

ITERIS, INC.  
Form 10-K  
June 21, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended March 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-08762

## ITERIS, INC.

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction  
of Incorporation or Organization)

**95-2588496**

(I.R.S. Employer  
Identification No.)

**1515 South Manchester Avenue, Anaheim, California 92802**

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: **(714) 774-5000**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Common Stock, \$0.10 par value

Name of each exchange on which registered

American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

## Edgar Filing: ITERIS, INC. - Form 10-K

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes  No

Based on the closing sale price of the registrant's common stock on September 30, 2006, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting common stock held by nonaffiliates of the registrant was \$54,700,000. For the purposes of this calculation, shares owned by officers, directors and 10% stockholders known to the registrant have been deemed to be owned by affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of June 18, 2007, there were 32,575,330 shares of common stock outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the registrant's definitive proxy statement for the 2007 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year ended March 31, 2007. Except with respect to information specifically incorporated by reference in this report, the registrant's proxy statement is not deemed to be filed as a part hereof.

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**ITERIS, INC.**

**ANNUAL REPORT ON FORM 10-K**

**FOR THE FISCAL YEAR ENDED MARCH 31, 2007**

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Unless otherwise indicated in this report, the registrant, we, us and our collectively refers to Iteris, Inc. (formerly known as Iteris Holdings, Inc. and Odetics, Inc.) and its former subsidiary, Meyer, Mohaddes Associates, Inc., which was dissolved effective April 3, 2006.

AutoVue®, Iteris® and Vantage® are among the registered trademarks of Iteris, Inc. Any other trademarks or trade names mentioned herein are the property of their respective owners.

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## Cautionary Statement

*This report, including the following discussion and analysis, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that are based on our current expectations, estimates and projections about our business and our industry, and reflect management's beliefs and certain assumptions made by us based upon information available to us as of the date of this report. When used in this report and the information incorporated herein by reference, the words expect(s), feel(s), believe(s), should, will, may, anticipate(s), estimate(s) and similar expressions or variations of these words are intended to identify forward-looking statements. These forward-looking statements include but are not limited to statements regarding our anticipated sales, revenue, expenses, profits, capital needs, competition, backlog and manufacturing capabilities, the practical market applications, future applications and acceptance of our products and services, the status of our facilities and product development. These statements are not guarantees of future performance and are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. You should not place undue reliance on these forward-looking statements that speak only as of the date hereof. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. We encourage you to carefully review and consider the various disclosures made by us which describe certain factors which could affect our business, including those in Risk Factors in Item 1A of this report, before deciding to invest in our company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statement for any reason.*

## PART I

### ITEM 1. BUSINESS

#### Overview

Iteris, Inc., formerly known as Iteris Holdings, Inc., is a leading provider of outdoor machine vision systems and sensors that optimize the flow of traffic and enhance driver safety. Using proprietary software and Intelligent Transportation Systems ( ITS ) industry expertise, we provide video sensor systems, transportation management and traveler information systems and other engineering and consulting services to the ITS industry. The ITS industry is comprised of companies applying a variety of technologies to enable the safe and efficient movement of people and goods. We use our outdoor image recognition software expertise to develop proprietary algorithms for video sensor systems that improve vehicle safety and the flow of traffic. Using our knowledge of the ITS industry, we design and implement transportation management systems that help public agencies reduce traffic congestion and provide greater access to traveler information.

We were originally incorporated in Delaware in 1987 as Odetics, Inc. and in September 2003 changed our name to Iteris Holdings, Inc. to reflect our focus on the ITS industry and our capital structure at that time. On October 22, 2004, we completed a merger with our majority-owned subsidiary, Iteris, Inc. (the Iteris Subsidiary ), and officially changed our corporate name from Iteris Holdings, Inc. to Iteris, Inc.

Our proprietary image recognition systems include Vantage and AutoVue. Vantage is a video vehicle detection system that detects the presence of vehicles on roadways. Vantage systems are used at signalized intersections to enable a more efficient allocation of green signal time and are also used for incident detection and highway traffic data collection applications. AutoVue Lane Departure Warning ( LDW ) systems consist of a small windshield mounted sensor that uses proprietary software to detect and warn drivers of unintended lane departures. To date, we and our strategic partner have sold approximately 83,000 production AutoVue LDW systems for use on car and truck platforms in the North American and European markets. We believe that our AutoVue LDW technology is a broad sensor platform that, through additional software development, may be expanded to incorporate additional safety and convenience features.

Our transportation management systems business includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers and advanced communications equipment to enable public agencies to monitor, control and direct traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design and implementation of surface transportation infrastructure systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting and systems engineering, and identify mitigation measures to reduce traffic congestion. These services and systems are primarily sold to local, state and national transportation agencies in the United States. Our transportation management systems business is largely dependent upon governmental

funding and budgetary issues. The Federal Highway Bill that was passed in August 2005 provided for a significant increase in transportation funding over the following six years. We believe the recent expansion of our transportation management systems business was due in part to the passage of the Federal Highway Bill, combined with the expansion of transportation funds at state and local agencies throughout the country.

We currently operate in three reportable segments: Roadway Sensors, Automotive Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage vehicle detection systems for traffic intersection control, incident detection and certain highway traffic data collection applications. The Automotive Sensors segment is comprised of all activities related to our AutoVue LDW systems for vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. See Note 12 to the accompanying consolidated financial statements for further discussion of our operating segments.

### **Sales, Marketing and Principal Customers**

We sell our Vantage vehicle detection systems through indirect sales channels comprised of independent dealers in the United States and Canada who sell integrated systems and related products to the traffic management market, as well as directly to the traffic management market using a combination of our own sales personnel and an outside sales organization. Our independent dealers are primarily responsible for sales, installation and support of Vantage systems. These dealers maintain an inventory of demonstration traffic products from various manufacturers including our Vantage vehicle detection systems and sell directly to government agencies and installation contractors. These dealers often have long-term arrangements with the government agencies in their territory for the supply of various products for the construction and renovation of traffic intersections. We hold technical training classes for dealers and end users and maintain a full-time staff of customer support technicians to provide technical assistance when needed.

Our marketing strategy for AutoVue is to establish it as the leading platform for in-vehicle video sensing for heavy trucks and passenger cars. We sell AutoVue LDW systems directly to heavy truck manufacturers and to U.S. truck fleets, and our AutoVue LDW system is currently offered as an option on certain heavy trucks, including Mercedes-Benz, MAN, Iveco, DAF, Scania, Freightliner, International and FUSO, as well as Neoplan and MAN luxury bus and coach lines. We market the licensing of our LDW technology to manufacturers of passenger automobiles through an exclusive strategic relationship with Valeo Schalter and Sensuren GmbH ( Valeo ), an independent automotive supplier. In connection with this marketing effort, we provide specific contract engineering services, technical marketing and sales support to Valeo, which to date has enabled the launch of our LDW technology on three Infiniti car platforms, the FX, M and Q, where our LDW system is offered as part of the technology option package. We plan to continue to provide technical marketing and sales support to Valeo in our efforts to win new original equipment manufacturer ( OEM ) customers for the passenger car market as well as contract engineering services related to the possible launch of new platforms that include our AutoVue LDW system.

We market and sell our transportation management systems and traveler information services directly to government agencies pursuant to negotiated contracts that involve competitive bidding and specific qualification requirements. Most of our contracts with federal, state and municipal customers provide for cancellation or renegotiation at the option of the customer upon reasonable notice and fees paid for modification. We use selected members of our engineering team divided on a regional basis to serve in sales and business development functions. We do not engage in sales of transportation management systems and traveler information services outside of the U.S. Sales of our transportation management systems contracts generally involve long lead times and require extensive specification development, evaluation and price negotiations.

Our largest customer accounted for 12.4% of total net sales and contract revenues in the fiscal year ended March 31, 2007 ( Fiscal 2007 ).

### **Manufacturing and Materials**

We use contract manufacturers to build subassemblies that are used in our Vantage products. Additionally, we procure certain components from qualified suppliers, both globally and locally, and use multi-sourcing strategies when technically and economically feasible to mitigate supply risk. These subassemblies and components are delivered to our Anaheim facility where they go through final assembly and testing prior to shipment to our customers. Our manufacturing activities are conducted in approximately 8,000 square feet of space at our Anaheim facility. Production volume at our subcontractors is based upon quarterly forecasts that we adjust on a monthly basis to control inventory. For sales of AutoVue LDW systems to the truck market, we subcontract the manufacture of our AutoVue LDW systems to two manufacturers, and our internal processes are limited primarily to testing and final verification. For AutoVue LDW sales to the passenger car market, we

anticipate that all manufacturing will be done by Valeo; however, we plan to continue to provide engineering support to Valeo. We currently do not manufacture any of the hardware used in the transportation management and traveler information systems that we design and implement. Our production facility is currently ISO 9001 certified.

### **Customer Support and Services**

We provide warranty service and support for our Vantage and AutoVue products, as well as follow-up service and support for which we charge separately. Service revenue accounted for less than 1.0% of total net sales and contract revenues for Fiscal 2007. We believe customer support is a key competitive factor.

### **Backlog**

Our backlog of unfulfilled firm orders was approximately \$25.7 million as of March 31, 2007, which was comprised of \$3.5 million related to Roadway Sensors, \$2.1 million related to Automotive Sensors and \$20.1 million related to Transportation Systems. Substantially all of the backlog for Roadway Sensors and Automotive Sensors is expected to be recognized as revenue in the fiscal year ending March 31, 2008 ( Fiscal 2008 ), while approximately 75.0% of Transportation Systems backlog is expected to be recognized as revenue in Fiscal 2008. At March 31, 2006, we had backlog of approximately \$20.3 million, which was comprised of \$1.5 million related to Roadway Sensors, \$3.0 million related to Automotive Sensors and \$15.8 million related to Transportation Systems. All backlog as of March 31, 2006 for Roadway Sensors and Automotive Sensors was recognized as revenue in Fiscal 2007 while 58.9% of March 31, 2006 backlog for Transportation Systems was recognized as revenue in Fiscal 2007. Pursuant to the customary terms of our agreements with government contractors and other customers, customers can generally cancel or reschedule orders with little or no penalties. Lead times for the release of purchase orders often depend upon the scheduling and forecasting practices of our individual customers, which also can affect the timing of the conversion of our backlog into revenues. For these reasons, among others, our backlog at a particular date may not be indicative of our future revenues.

### **Product Development**

Most of our development activities are conducted at our principal facilities in Anaheim, California. Our company-sponsored research and development costs and expenses were approximately \$4.0 million for Fiscal 2007, \$5.2 million for the fiscal year ended March 31, 2006 ( Fiscal 2006 ), and \$6.2 million for the fiscal year ended March 31, 2005 ( Fiscal 2005 ). We expect to continue to pursue significant product development programs and incur significant research and development expenditures.

### **Competition**

We generally face significant competition in each of our target markets. Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition and results of operations. We believe that AutoVue is the only established commercially-available lane departure warning system used in the U.S. and in Europe in the heavy truck market. Potential competitors of AutoVue include Delphi Automotive Systems Corporation, NEC Corporation and Hitachi Ltd. in Japan and Robert Bosch GmbH in Europe, as well as Siemens, Continental Tavis, Visteon and Cognex, which could be currently developing video sensor technologies for the vehicle industry that could be used for lane departure warning systems. In the market for our Vantage vehicle detection systems, we compete with manufacturers of other above ground video camera detection systems such as Econolite Control Products, Inc., Traficon, N.V., Quixote, and other non-intrusive detection devices including microwave, infrared, ultrasonic and magnetic detectors, as well as manufacturers and installers of in-pavement inductive loop products.

The transportation management and traveler information systems market is highly fragmented and is subject to evolving national and regional quality and safety standards. Our competitors vary in number, scope and breadth of the products and services they offer. Our competitors in advanced transportation management and traveler information systems include national corporations such as Transcore, Siemens, Telvent Farradyne, Kimley-Horn and Associates, Inc. and Delcan. Our competitors in transportation engineering, planning and design include major firms such as Parsons Brinkerhoff, Inc., URS, HNTB and Parsons Transportation Group, Inc., as well as many smaller regional engineering firms.

In general, the markets for the products and services we offer are highly competitive and are characterized by rapidly changing technology and evolving standards. Many of our current and prospective competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, technical, manufacturing, distribution and marketing resources than us. As a result, they may be able to adapt more quickly to new or emerging standards or technologies or to devote greater resources to the promotion and sale of their products. It is also possible that new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We believe that our ability to compete effectively in our target markets will depend on a number of factors, including the success and timing of our new product development, the compatibility of our products with a broad range of computing systems, product quality and





performance, reliability, functionality, price, and service and technical support. Our failure to provide services and develop and market products that compete successfully with those of other suppliers and consultants in our target markets would have a material adverse effect on our business, financial condition and results of operations.

### **Intellectual Property and Proprietary Rights**

Our ability to compete effectively depends in part on our ability to develop and maintain the proprietary aspects of our technology. Our policy is to obtain appropriate proprietary rights protection for any potentially significant new technology acquired or developed by us. We currently hold ten U.S. patents, which expire commencing in 2012, and have six U.S. patent applications pending relating to our outdoor image processing techniques used in our AutoVue systems. Nine of our patents relate specifically to our AutoVue technology and provide a basis for enhanced functionality for rain sensing and improved performance. We believe that our other patents, while important for our technology platforms, are less critical to our near term product strategy. We cannot assure you that any new patents will be granted pursuant to any outstanding or subsequent applications.

In addition to patent laws, we rely on copyright and trade secret laws to protect our proprietary rights. We attempt to protect our trade secrets and other proprietary information through agreements with customers and suppliers, proprietary information agreements with our employees and consultants, and other similar measures. We do not have any material licenses or trademarks other than those relating to product names. We cannot be certain that we will be successful in protecting our proprietary rights. While we believe our patents, patent applications, software and other proprietary know-how have value, changing technology makes our future success dependent principally upon our employees' technical competence and creative skills for continuing innovation.

Litigation may be necessary in the future to enforce our proprietary rights, to determine the validity and scope of the proprietary rights of others, or to defend us against claims of infringement or invalidity by others. An adverse outcome in such litigation or similar proceedings could subject us to significant liabilities to third parties, require disputed rights to be licensed from others or require us to cease marketing or using certain products, any of which could have a material adverse effect on our business, financial condition and results of operations. In addition, the cost of addressing any intellectual property litigation claim, both in legal fees and expenses, as well as from the diversion of management's resources, regardless of whether the claim is valid, could be significant and could have a material adverse effect on our business, financial condition and results of operations.

### **Employees**

We refer to our employees as associates. As of June 5, 2007, we employed an aggregate of 237 associates, including 57 associates in general management, administration and finance; 31 associates in sales and marketing; 113 associates in engineering and product development; 25 associates in operations, manufacturing and quality; and 11 associates in customer service. None of our associates are represented by a labor union, and we have never experienced a work stoppage.

### **Government Regulation**

Our manufacturing operations are subject to various federal, state and local laws and regulations, including those restricting the discharge of materials into the environment. We are not involved in any pending or, to our knowledge, threatened governmental proceedings, which would require curtailment of our operations because of such laws and regulations. We continue to expend funds in connection with our compliance with applicable environmental regulations. These expenditures have not, however, been significant in the past, and we do not expect any significant expenditure in the near future. Currently, compliance with foreign laws has not had a material impact on our business and is not expected to have a material impact in the near future.

**ITEM 1A. RISK FACTORS**

*Our business is subject to a number of risks, some of which are discussed below. Other risks are presented elsewhere in this report and in the information incorporated by reference into this report. You should consider the following risks carefully in addition to the other information contained in this report and our other filings with the SEC, including our subsequent reports on Forms 10-Q and 8-K, before deciding to buy, sell or hold our common stock. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occurs, our business, financial condition or results of operations could be seriously harmed. In that event, the market price for our common stock could decline and you may lose all or part of your investment.*

**We May Need To Raise Additional Capital In The Future, Which May Not Be Available On Terms Acceptable To Us, Or At All.** We have generated significant net losses and operating losses in recent periods, and have experienced volatility in our cash flows from operations ranging from positive cash flows from operations of \$590,000 in the year ended March 31, 2005 to negative cash flows from operations of \$2.0 million in the year ended March 31, 2007. Additionally, we failed to meet certain debt covenants under our prior credit agreement in two of our last seven fiscal quarters, but replaced that credit facility in October 2006 as further described in Note 5 to the accompanying consolidated financial statements. Furthermore, we have \$9.9 million in subordinated convertible debentures that are due in full in May 2009. Should the holders of the convertible debentures not elect to convert the principal into shares of our common stock, we may need to raise additional capital to refinance this debt.

At March 31, 2007, we had \$35,000 of cash and cash equivalents and relied on our line of credit to fund our operations. We may need to raise additional capital in the near future to fund our operations or to repay indebtedness. Such additional capital may be raised through bank borrowings, or other debt or equity financings. We cannot assure you that any additional capital will be available on a timely basis, on acceptable terms, or at all, and such additional financing may result in further dilution to our stockholders.

Our capital requirements will depend on many factors, including, but not limited to:

- market acceptance of our products and product enhancements, and the overall level of sales of our products;
- our ability to control costs;
- the supply of key components for our products;
- our ability to generate net income;
- increased research and development expenses;
- increased sales and marketing expenses;
- technological advancements and our competitors' response to our products;
- capital improvements to new and existing facilities and enhancements to our infrastructure and systems;
- potential acquisitions of businesses and product lines;
- our relationships with customers and suppliers;
- government budgets, political agendas and other funding issues, including potential delays in government contract awards;

- our ability to successfully negotiate credit arrangements with our bank; and

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- general economic conditions, including the effects of the current economic slowdown and international conflicts.

If our capital requirements are materially different from those currently planned, we may need additional capital sooner than anticipated. If additional funds are raised through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and such securities may have rights, preferences and privileges senior to our common stock. Additional financing may not be available on favorable terms, on a timely basis, or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue our operations as planned, develop or enhance our products, expand our sales and marketing programs, take advantage of future opportunities or respond to competitive pressures.

**We Have Historically Experienced Substantial Losses And May Continue To Experience Losses For The Foreseeable Future.**

Although we have achieved net income in recent periods, we experienced a net loss of \$11.3 million in the year ended March 31, 2005. We cannot assure you that we will be able to sustain or improve our financial performance, or that we will be able to continue to achieve profitability on a quarterly or annual basis in the future. Most of our expenses are fixed in advance. As such, we generally are unable to reduce our expenses significantly in the short-term to compensate for any unexpected delay or decrease in anticipated revenues. As a result, we may continue to experience operating losses and net losses, which would make it difficult to fund our operations and achieve our business plan, and could cause the market price of our common stock to decline.

**If Our Internal Controls Over Financial Reporting Do Not Comply With The Requirements Of The Sarbanes-Oxley Act, Our Business And Stock Price Could Be Adversely Affected.** Along with our independent registered public accounting firm, we will be evaluating the effectiveness of our internal controls over financial reporting to comply with Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 currently requires us to evaluate the effectiveness of our internal controls over financial reporting at the end of each fiscal year beginning in our fiscal year ending March 31, 2008 and to include a management report assessing the effectiveness of our internal controls over financial reporting in all annual reports beginning with our Annual Report on Form 10-K for the fiscal year ending March 31, 2008. Section 404 also requires our independent accountant to attest to, and report on, management's assessment of our internal controls over financial reporting. We may not be able to complete our Section 404 compliance on a timely basis and even if we timely complete our compliance requirements, our independent auditors may still conclude that our internal controls over financial reporting are not effective.

Our management, including our CEO and CFO, does not expect that our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been, or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

As of March 31, 2005, we became aware of a material weakness in our internal controls related to the accounting for the consolidation of our deferred compensation savings plan and certain contract administration. We cannot assure you that we or our independent registered public accounting firm will not identify additional material weaknesses in our internal controls. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Based on our evaluation, our management concluded that, as of March 31, 2004, our internal control over financial reporting was not effective due to the existence of one material weakness. We may experience additional material weaknesses in the future. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.



**We May Experience Production Gaps Which Could Materially And Adversely Impact Our Sales And Financial Results And The Ultimate Acceptance Of Our Products.** It is possible that we could experience unforeseen quality control issues or part shortages as we increase production to meet current demand of our products. We have historically used single suppliers for certain of our components in our AutoVue and Vantage products. Should any such delay or disruption occur, our future sales will likely be materially and adversely affected. Additionally, we rely heavily on select contract manufacturers to produce many of our products. Although we believe our contract manufacturers have sufficient capacity to meet our production schedules for the foreseeable future and we believe we could find alternative contract manufacturing sources if necessary, we could experience a production gap if for any reason our contract manufacturers were unable to meet our production requirements.

**We Depend Upon Valeo To Market Our AutoVue Technologies For The OEM Passenger Car Market.** We have granted Valeo the exclusive right to sell and manufacture our AutoVue LDW system to the worldwide passenger car market in exchange for royalty payments for each AutoVue unit sold. As such, the future success and broad market acceptance of our AutoVue technologies in the passenger car market will depend upon Valeo's ability to manufacture, market and sell our technologies, and to convince more OEM passenger car manufacturers to adopt our technologies. If Valeo does not devote considerable resources and aggressively pursue opportunities, our expansion into the passenger car market could be adversely affected.

**We May Be Unable To Attract And Retain Key Personnel, Which Could Seriously Harm Our Business.** Due to the specialized nature of our business, we are highly dependent on the continued service of our executive officers and other key management, engineering and technical personnel. The loss of any of our executive officers or key members of management could adversely affect our business, financial condition or results of operations. Our success will also depend in large part upon our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. In particular, the future success of our Transportation Systems segment will depend on our ability to hire additional qualified engineers and planners. Competition for qualified employees, particularly development engineers, is intense. We may not be able to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

**If We Are Unable To Develop And Introduce New Products And Product Enhancements Successfully And In A Cost-Effective And Timely Manner, Or Are Unable To Achieve Market Acceptance Of Our New Products, Our Operating Results Would Be Adversely Affected.** We believe our revenue growth and future operating results will depend on our ability to complete development of new products and enhancements, introduce these products in a timely, cost-effective manner, achieve broad market acceptance of these products and enhancements, and reduce our product costs. We cannot guarantee the success of these products and we may not be able to introduce any new products or any enhancements to our existing products on a timely basis, or at all. In addition, the introduction of any new products could adversely affect the sales of certain of our existing products.

We believe that we must continue to make substantial investments to support ongoing research and development in order to remain competitive. We need to continue to develop and introduce new products that incorporate the latest technological advancements in outdoor image processing hardware, software and camera technologies in response to evolving customer requirements. We cannot assure you that we will be able to adequately manage product transition issues. Our business and results of operations could be adversely affected if we do not anticipate or respond adequately to technological developments or changing customer requirements or if we cannot adequately manage inventory issues typically related to new product transitions and introductions. We cannot assure you that any such investments in research and development will lead to any corresponding increase in revenue.

Market acceptance of our new products depends upon many factors, including our ability to accurately predict market requirements and evolving industry standards, our ability to resolve technical challenges in a timely and cost-effective manner, qualify any new products with OEMs and achieve manufacturing efficiencies, the perceived advantages of our new products over traditional products and the marketing capabilities of our independent distributors and strategic partners, including Valeo's ability to expand sales of AutoVue in the passenger car market. The success of our AutoVue system will also depend in part on the success of the automotive vehicles that incorporate our technology, as well as the success of optional equipment that OEMs bundle with our technologies.



Certain of the components used in our Vantage and AutoVue products may need to be re-engineered in the next 12 to 18 months as the industry is moving towards a standard of using lead-free components. We cannot assure you as to the timing of the adoption of this new standard or our ability to successfully redesign our products to incorporate compliant components and gain market acceptance of such redesigned products. In addition, if the standard is adopted earlier than anticipated we may experience a shortage of Vantage and AutoVue products as a result of potential scarcity of lead-free components.

Our business and results of operations could also be seriously harmed by any significant delays in our new product development. Certain of our new products could contain undetected design faults and software errors or bugs when first released by us, despite our testing. We may not discover these faults or errors until after a product has been installed and used by our customers. Any faults or errors in our existing products or in any new products may cause delays in product introduction and shipments, require design modifications or harm customer relationships, any of which could adversely affect our business and competitive position.

**The Markets In Which We Operate Are Highly Competitive And Have Many More Established Competitors, Which Could Adversely Affect Our Sales Or The Market Acceptance Of Our Products.** We compete with numerous other companies in our target markets including, but not limited to, large, multinational corporations, which include tier one automotive suppliers, and many smaller regional engineering firms. We expect such competition to increase due to technological advancements, industry consolidations and reduced barriers to entry. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could seriously harm our business, financial condition and results of operations. We have experienced more competition in our Roadway Sensors segment in Fiscal 2007 as the Department of Transportation in one of our largest sales territories has recently moved to a multi-source contracting environment from one in which Iteris was the sole supplier. In addition, one of the other developers of LDW systems was recently acquired by a larger company. While this developer has not been a material competitor to date, we may experience more competition from this provider as a result of its greater access to resources from its acquirer, and additional competitors may enter this market in the future.

Many of our competitors have far greater name recognition and greater financial, technological, marketing and customer service resources than we do. This may allow them to respond more quickly to new or emerging technologies and changes in customer requirements. It may also allow them to devote greater resources to the development, promotion, sale and support of their products than we can. Recent consolidations of end users, distributors and manufacturers in our target markets have exacerbated this problem. As a result of the foregoing factors, we may not be able to compete effectively in our target markets and competitive pressures could adversely affect our business, financial condition and results of operations.

**An Economic Slowdown Or The Significant Military Operations In The Middle East Or Elsewhere May Impact Government Funding Or Consumer Spending, Causing A Decline In Our Revenues.** In the near term, the funding of U.S. military operations in the Middle East or elsewhere may cause disruptions in funding of government contracts. Since military operations of such magnitude are not routinely included in U.S. defense budgets, supplemental legislative funding actions are often required to finance such operations. Even when such legislation is enacted, it may not be adequate for ongoing operations, causing other government resources to be temporarily or permanently diverted. Since a significant portion of our sales are derived from contracts with government agencies, such diversion of funds could produce interruptions in funding or delays in receipt of our contracts, causing disruptions and adversely affecting our revenue and operations.

Concerns about the recent international conflicts and terrorist and military actions, as well as concerns about inflation, decreased consumer confidence, and reduced corporate profits and capital spending have also resulted in a downturn in worldwide economic conditions, particularly in the United States. These unfavorable economic conditions may have a negative impact on customer orders (and also may result in decreased sales of automobiles and trucks that incorporate our LDW systems). Such concerns may result in cancellations and rescheduling of backlog. In addition, the recent decline in the U.S. real estate market, particularly in new home construction, could adversely impact new road construction resulting in a decline in Roadway Sensor and Automotive Sensor net sales and Transportation Systems contract revenues. Any of the foregoing political, social and economic conditions make it extremely difficult for our customers, our suppliers and us to accurately forecast and plan future business activities and could result in a decline in our net sales and contract revenues. If such conditions continue or worsen, our business, financial condition and results of operations could be materially and adversely affected.

**New Environmental Regulations May Result In A Decline In Our AutoVue Sales and Royalties.** Recent environmental regulations were effected in Europe effective in 2006, which required more stringent emissions compliance in





new trucks manufactured in Europe after 2006. These regulations caused the cost of certain trucks to increase significantly and could cause a decline in new truck sales in Europe in the near future. Similar regulations have been announced in North America that may impact diesel engines built after January 2007, which could similarly impact North American OEM truck sales in general. We may experience a decline in our LDW sales to truck OEMs related to these stricter regulations.

**We Depend On Government Contracts And Subcontracts, And Because Many Of Our Government Contracts Are Fixed Price Contracts, Higher Than Anticipated Costs Will Reduce Our Profit And Could Adversely Impact Our Operating Results.** A significant portion of our sales are derived from contracts with governmental agencies, either as a general contractor, subcontractor or supplier. Government contracts represented approximately 37.8%, 38.3% and 37.4% of our total net sales and contract revenues for the years ended March 31, 2007, 2006 and 2005, respectively. We anticipate that revenue from government contracts will continue to increase in the near future. Government business is, in general, subject to special risks and challenges, including:

- long purchase cycles or approval processes;
- competitive bidding and qualification requirements;
- the impact of international conflicts;
- performance bond requirements;
- changes in government policies and political agendas;
- delays in funding, including the delays in the allocation of funds to state and local agencies from the U.S. Federal Highway Bill;
- other government budgetary constraints and cut-backs; and
- milestone requirements and liquidated damage provisions for failure to meet contract milestones.

In addition, a large number of our government contracts are fixed price contracts. As a result, we may not be able to recover any cost overruns we may incur. These fixed price contracts require us to estimate the total project cost based on preliminary projections of the project's requirements. The financial viability of any given project depends in large part on our ability to estimate these costs accurately and complete the project on a timely basis. In the event our costs on these projects exceed the fixed contractual amount, we will be required to bear the excess costs. Such additional costs would adversely affect our financial condition and results of operations. Moreover, certain of our government contracts are subject to termination or renegotiation at the convenience of the government, which could result in a large decline in our net sales and contract revenues in any given quarter. Our inability to address any of the foregoing concerns or the loss or renegotiation of any material government contract could seriously harm our business, financial condition and results of operations.

**Our Quarterly Operating Results Fluctuate As A Result Of Many Factors. Therefore, We May Fail To Meet Or Exceed The Expectations Of Securities Analysts And Investors, Which Could Cause Our Stock Price To Decline.** Our quarterly revenues and operating results have fluctuated and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. Factors that could affect our revenues include, among others, the following:

- changes in our pricing policies and the pricing policies of our suppliers and competitors, pricing concessions on volume sales, as well as increased price competition in general;
- the long lead times associated with government contracts or required by vehicle manufacturers;
- delays in government contracts from time to time, including from delays in the allocation of funds to state and local agencies from the U.S. Federal Highway Bill;

- our ability to raise additional capital;

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- our ability to control costs;
- the mix of our products and services sold in a quarter, which mix has varied and is expected to continue to vary from time to time;
- seasonality due to winter weather conditions;
- international conflicts and acts of terrorism;
- declines in new home construction and related road construction;
- our ability to develop, introduce, patent, market and gain market acceptance of new products, applications and product enhancements in a timely manner, or at all;
- market acceptance of the products incorporating our technologies and products;
- the size, timing, rescheduling or cancellation of significant customer orders;
- the introduction of new products by competitors;
- the availability and cost of components used in the manufacture of our products;
- our success in expanding and implementing our sales and marketing programs;
- the effects of technological changes in our target markets;
- the amount of our backlog at any given time;
- the nature of our government contracts;
- deferrals of customer orders in anticipation of new products, applications or product enhancements;
- risks and uncertainties associated with our international business;
- currency fluctuations and our ability to get currency out of certain foreign countries; and
- general economic and political conditions.

Due to all of the factors listed above as well as other unforeseen factors, our future operating results could be below the expectations of securities analysts or investors. If that happens, the trading price of our common stock could decline. As a result of these quarterly variations, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance.

**We May Engage In Acquisitions Of Companies Or Technologies That May Require Us To Undertake Significant Capital Infusions And Could Result In Disruptions Of Our Business And Diversion Of Resources And Management Attention.** We have historically acquired, and may in the future acquire, complementary businesses, products and technologies. Acquisitions may require significant capital infusions and, in general, acquisitions also involve a number of special risks, including:

- potential disruption of our ongoing business and the diversion of our resources and management s

attention;

- the failure to retain or integrate key acquired personnel;

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- the challenge of assimilating diverse business cultures, and the difficulties in integrating the operations, technologies and information system of the acquired companies;
- increased costs to improve managerial, operational, financial and administrative systems and to eliminate duplicative services;
- the incurrence of unforeseen obligations or liabilities;
- potential impairment of relationships with employees or customers as a result of changes in management; and
- increased interest expense and amortization of acquired intangible assets.

Our competitors are also soliciting potential acquisition candidates, which could both increase the price of any acquisition targets and decrease the number of attractive companies available for acquisition. Acquisitions may also materially and adversely affect our operating results due to large write-offs, contingent liabilities, substantial depreciation, deferred compensation charges or intangible asset amortization, or other adverse tax or accounting consequences. We cannot assure you that we will be able to identify or consummate any additional acquisitions, successfully integrate any acquisitions or realize the benefits anticipated from any acquisition.

**We Have Experienced Growth In Recent Periods. If We Fail To Manage Our Growth Effectively, We May Be Unable To Execute Our Business Plan And May Experience Future Weaknesses In Our Internal Controls.** We have expanded our overall business. In order to achieve our business objectives, we will need to continue to expand our business and add additional qualified personnel. Such expansion has placed and is expected to continue to place, a significant strain on our managerial, administrative, operational, financial and other resources. If we are unable to successfully manage our growth, our business, financial condition and results of operations will be adversely affected.

To accommodate this growth, we launched a new ERP system in April 2006. Accordingly, we may experience problems commonly experienced by other companies in connection with such implementations, including but not limited to, potential bugs in the system, component or supply delays, training requirements and other integration challenges and delays. Any difficulties we might experience in connection with our new ERP system could have a material adverse effect on our financial reporting system and internal controls.

**If We Do Not Keep Pace With Rapid Technological Changes And Evolving Industry Standards, We Will Not Be Able To Remain Competitive And There Will Be No Demand For Our Products.** Our markets are in general characterized by the following factors:

- rapid technological advances;
- downward price pressure in the marketplace as technologies mature;
- changes in customer requirements;
- frequent new product introductions and enhancements; and
- evolving industry standards and changes in the regulatory environment.

Our future success will depend upon our ability to anticipate and adapt to changes in technology and industry standards, and to effectively develop, introduce, market and gain broad acceptance of new products and product enhancements incorporating the latest technological advancements. In particular, our LDW system is incorporated into automobiles and trucks that face significant technological changes in each model year and among different vehicle models. Accordingly, we must adapt our technology from time to time to function with such changes.

**We May Not Be Able To Adequately Protect Or Enforce Our Intellectual Property Rights, Which Could Harm Our Competitive Position.** If we are not able to adequately protect or enforce the proprietary aspects of our technology, competitors

could be able to access our proprietary technology and our business, financial condition and results of operations

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will likely be seriously harmed. We currently attempt to protect our technology through a combination of patent, copyright, trademark and trade secret laws, employee and third party nondisclosure agreements and similar means. Despite our efforts, other parties may attempt to disclose, obtain or use our technologies or systems. Our competitors may also be able to independently develop products that are substantially equivalent or superior to our products or design around our patents. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. As a result, we may not be able to protect our proprietary rights adequately in the United States or abroad.

Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation may also be necessary to defend against claims of infringement or invalidity by others. An adverse outcome in litigation or any similar proceedings could subject us to significant liabilities to third parties, require us to license disputed rights from others or require us to cease marketing or using certain products or technologies. We may not be able to obtain any licenses on terms acceptable to us, or at all. We also may have to indemnify certain customers or strategic partners if it is determined that we have infringed upon or misappropriated another party's intellectual property. Any of these results could adversely affect our business, financial condition and results of operations. In addition, the cost of addressing any intellectual property litigation claim, including legal fees and expenses, and the diversion of management's attention and resources, regardless of whether the claim is valid, could be significant and could seriously harm our business, financial condition and results of operations.

**The Trading Price Of Our Common Stock Is Highly Volatile.** The trading price of our common stock has been subject to wide fluctuations in the past. Since January 2000, our Class A common stock (now known as our common stock) has traded at prices as low as \$0.45 per share and as high as \$29.44 per share. The market price of our common stock could continue to fluctuate in the future in response to various factors, including, but not limited to:

- quarterly variations in operating results;
- our ability to control costs, improve cash flow and sustain profitability;
- our ability to raise additional capital;
- shortages announced by suppliers;
- announcements of technological innovations or new products or applications by our competitors, customers or us;
- transitions to new products or product enhancements;
- acquisitions of businesses, products or technologies;
- the impact of any litigation;
- changes in investor perceptions;
- government funding, political agendas and other budgetary issues;
- changes in earnings estimates or investment recommendations by securities analysts; and
- international conflicts, political unrest and acts of terrorism.

In addition, as of March 31, 2007, options to purchase an aggregate of 711,000 shares of our common stock at a weighted average price of \$0.53 per share terminate on or prior to September 30, 2007. Our common stock has traditionally been thinly traded. The exercise of these options and the sale of a large number of shares of our common stock could cause our stock price to decline.



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The stock market in general has recently experienced volatility, which has particularly affected the market prices of equity securities of many technology companies. This volatility has often been unrelated to the operating performance of these

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companies. These broad market fluctuations may adversely affect the market price of our common stock. In the past, companies that have experienced volatility in the market price of their securities have been the subject of securities class action litigation. If we were to become the subject of a class action lawsuit, it could result in substantial losses and divert management's attention and resources from other matters.

**Our International Business Operations May Be Threatened By Many Factors That Are Outside Of Our Control.** We currently market our AutoVue and Vantage products internationally and we anticipate that our international operations will expand in the near future. International business operations are subject to various inherent risks including, among others:

- currency fluctuations and restrictions;
- political, social and economic instability;
- longer accounts receivable payment cycles;
- import and export license requirements and restrictions of the United States and each other country in which we operate;
- unexpected changes in regulatory requirements, tariffs and other trade barriers or restrictions;
- the burdens of compliance with a wide variety of foreign laws and more restrictive labor laws and obligations;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences; and
- reduced protection for intellectual property rights in some countries.

All of our international sales are denominated in U.S. dollars. As a result, an increase in the relative value of the dollar could make our products more expensive and potentially less price competitive in international markets. We do not engage in any transactions as a hedge against risks of loss due to foreign currency fluctuations.

Any of the factors mentioned above may adversely affect our future international sales and, consequently, affect our business, financial condition and operating results. Furthermore, as we increase our international sales, our total revenues may also be affected to a greater extent by seasonal fluctuations resulting from lower sales that typically occur during the summer months in Europe and other parts of the world.

**We Could Experience Negative Financial Impacts Arising From Developments In Contingencies Created Under Our Previous Structure Or By Former Subsidiaries.** Although we divested ourselves of all business units, with the exception of our Iteris business, from time to time we could experience unforeseen developments in contingencies related to our former subsidiaries. For example, in July 2006 we entered into a settlement agreement in connection with a lawsuit brought against Mariner Networks, Inc., one of our former subsidiaries, by one of Mariner's suppliers, pursuant to which we issued 88,912 shares of our common stock to this supplier (valued at \$213,000 as of the date of issuance), paid this supplier \$125,000 on October 20, 2006 and are required to pay an additional \$350,000 in 36 equal monthly installments of \$9,700 beginning in November 2006. Although we are not aware of any other material contingencies, it is possible that other matters could be brought against us in connection with activities related to former subsidiaries and that such matters could materially and adversely affect our financial results and cash flows.

**Some Of Our Directors, Officers And Their Affiliates Can Control The Outcome Of Matters That Require The Approval Of Our Stockholders, And Accordingly We Will Not Be Able To Engage In Certain Transactions Without Their Approval.** As of March 31, 2007, our officers and directors beneficially owned approximately 12% of the outstanding shares of our common

stock (and approximately 18% of our common stock when including options, warrants and other convertible securities held by them which are currently exercisable or convertible or will become exercisable or convertible within 60 days

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after March 31, 2007). As a result of their stock ownership, our management will be able to significantly influence the election of our directors and the outcome of corporate actions requiring stockholder approval, such as mergers and acquisitions, regardless of how our other stockholders may vote. This concentration of voting control may have a significant effect in delaying, deferring or preventing a change in our management or change in control and may adversely affect the voting or other rights of other holders of common stock.

**Certain Anti-Takeover Provisions May Affect The Price Of Our Common Stock And Discourage A Third Party From Acquiring Us.** Certain provisions of our certificate of incorporation and our stockholder rights plan could make it difficult for a third party to acquire us, even though an acquisition might be beneficial to our stockholders. Such provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. Under the terms of our certificate of incorporation, our Board of Directors is authorized to issue, without stockholder approval, up to 2,000,000 shares of preferred stock with voting, conversion and other rights and preferences superior to those of our common stock. Our future issuance of preferred stock could be used to discourage an unsolicited acquisition proposal. In addition, in March 1998, we adopted a stockholder rights plan and declared a dividend of preferred stock purchase rights to our stockholders. We amended this plan in May 2004. In the event a third party acquires more than 15% of the outstanding voting control of our company or 15% of our outstanding common stock, the holders of these rights will be able to purchase the junior participating preferred stock at a substantial discount off of the then current market price. The exercise of these rights and purchase of a significant amount of stock at below market prices could cause substantial dilution to a particular acquirer and discourage the acquirer from pursuing our company. The mere existence of a stockholder rights plan often delays or makes a merger, tender offer or proxy contest more difficult.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

Our headquarters and principal operations are housed in approximately 94,000 square feet of leased space located at 1515 South Manchester Boulevard in Anaheim, California, for which we pay a monthly lease rate of \$92,000, exclusive of common area maintenance and certain utility costs. The Anaheim facility includes our operations and administrative offices (approximately 84,000 dedicated square feet) and the operations of our former subsidiary, MAXxess Systems, Inc. (approximately 10,000 dedicated square feet). The lease for the Anaheim facility is expected to terminate in September 2007.

On May 25, 2007, we entered into an agreement to lease approximately 50,000 square feet of space located in Santa Ana, California for a term of 88 months, beginning in September 2007. This location will be the new location of our headquarters and principal operations. The monthly lease rate will be \$102,000, inclusive of common area maintenance costs and certain utility costs, during the first year of the lease, and will increase each year thereafter, up to a maximum of \$120,000 during the last year of the lease. The lease may be extended for a period of five years, at our option, at a lease rate to be based on the market lease rate for comparable property determined as of the commencement of the extension period. Subject to certain limitations, we also have a right of first offer with respect to additional space at the same location.

For additional information regarding our obligations under property leases, see Note 7 of Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this report.

**ITEM 3. LEGAL PROCEEDINGS**

The information set forth under Note 7 of Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this report, is incorporated herein by reference.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our security holders during the three months ended March 31, 2007.



## PART II

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the American Stock Exchange ( AMEX ) under the symbol ITI . The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by AMEX:

	Common Stock High	Low
<b>Fiscal 2007</b>		
Quarter Ended June 30, 2006	\$ 2.69	\$ 2.10
Quarter Ended September 30, 2006	2.69	2.26
Quarter Ended December 31, 2006	2.69	1.38
Quarter Ended March 31, 2007	2.76	2.15
<b>Fiscal 2006</b>		
Quarter Ended June 30, 2005	\$ 2.89	\$ 2.00
Quarter Ended September 30, 2005	3.40	2.57
Quarter Ended December 31, 2005	2.80	2.02
Quarter Ended March 31, 2006	2.80	1.85

On June 18, 2007, the last reported sales price of our common stock on the AMEX was \$2.53. As of June 18, 2007, we had 526 holders of record of our common stock according to information furnished by our transfer agent.

**Dividend Policy**

We have never paid or declared cash dividends on our common stock, and have no current plans to pay such dividends in the foreseeable future. We currently intend to retain any earnings for working capital and general corporate purposes. The payment of any future dividends will be at the discretion of our Board of Directors and will depend upon a number of factors, including, but not limited to, future earnings, the success of our business, our capital requirements, our general financial condition and future prospects, general business conditions, the consent of our lender and such other factors as the Board of Directors may deem relevant.

**Recent Sales of Unregistered Securities**

The following is a summary of our transactions during the year ended March 31, 2007, involving sales of our securities that were not registered under the Securities Act of 1933, as amended (the Securities Act ):

- (1) In August 2006, we issued to Delta Networks, Inc. 88,912 shares of our common stock valued at \$213,000 in connection with the settlement of a lawsuit by Delta against one of our former subsidiaries, Mariner Networks, Inc.
- (2) In September 2006, we issued to Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P. (collectively, the Funds ) warrants to purchase an aggregate of 246,250 shares of our common stock, subject to adjustment in specified circumstances, in connection with the early exercise by the Funds of existing warrants to purchase an aggregate of 1,250,000 shares of common stock at an exercise price of \$1.61 per share. We received \$2.0 million from the Funds as payment in full of the aggregate exercise price of such existing warrants. The new warrants are immediately exercisable, have an exercise price of \$3.25 per share, subject to adjustment in specified circumstances, and expire in September 2011. We may redeem all of the warrants, at a price of \$0.01 per share of common stock then purchaseable pursuant to the warrants if the closing bid price of one share of common stock equals or exceeds \$6.50 for 20 consecutive trading days, subject to the rights of the holders thereof to exercise the warrants prior to the redemption date. In order to exercise this redemption option, we must redeem all of the warrants on the same terms.



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The issuance of securities in the transactions described in paragraphs 1 and 2 above were effected without registration under the Securities Act in reliance on Section 4(2) thereof and Rule 506 of Registration D thereunder based on the status of each investor as an accredited investor defined under the Securities Act. None of the foregoing transactions was effected using any form of general advertising or general solicitation as such terms are used in Regulation D under the Securities Act.

### **Stock Performance Graph**

The graph below shows the cumulative total return on investment assuming an investment of \$100 on March 31, 2002 in our common stock, the NASDAQ Stock Market Index and the same peer group used by us last year, which is made up of the remaining members of the index used by us in prior years, the Media General Industry Group 836 for Diversified Electronics, which is no longer a published index. Our common stock is currently listed on the AMEX under the symbol ITI and began trading on such exchange on December 9, 2004. Our common stock (formerly the Class A common stock) was listed on the NASDAQ National Market (now called the NASDAQ Global Market) until April 2002 and on the NASDAQ SmallCap Market (now called the NASDAQ Capital Market) from April 2002 to August 2003 and quoted on the OTC Bulletin Board from August 2003 to December 2004. The total stockholder return assumes reinvestment of dividends on a daily basis, although cash dividends have not been declared on our common stock. The stockholder returns shown in the following graph are not necessarily indicative of future performance.

**Measurement Period**



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	2002	2003	2004	2005	2006	2007
Iteris Common Stock	100.00	42.58	258.06	157.42	170.32	148.39
NASDAQ Market Index	100.00	72.11	109.76	111.26	132.74	139.65
Peer Group	100.00	62.01	111.93	85.59	112.90	114.99

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Notwithstanding anything to the contrary set forth in any of our previous or future filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, that might incorporate this report or future filings made by us under those statutes, the stock performance graph is not deemed filed with the Securities and Exchange Commission and shall not be deemed incorporated by reference into any prior filings or into any future filings made by us under those statutes.

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following table sets forth selected consolidated financial data for each of the five fiscal years ended March 31, 2007. The statement of operations and balance sheet data for the years ended and as of March 31, 2007, 2006, 2005, 2004, and 2003 are derived from our audited consolidated financial statements. The accompanying consolidated financial statements have been restated to reflect the classification and presentation of our former subsidiaries, Broadcast, Inc., Zyfer Inc., and MAXxess Systems, Inc., as discontinued operations for all periods presented. The following information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and with our consolidated financial statements and the related notes thereto included elsewhere in this report.

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	<b>Fiscal Year Ended March 31,</b>				
	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands, except per share data)</b>				
<b>Consolidated Statement of Operations Data:</b>					
Net sales and contract revenues:					
Net sales	\$ 36,248	\$ 31,156	\$ 29,062	\$ 23,470	\$ 19,112
Contract revenues	22,049	19,330	17,335	21,813	22,283
Total net sales and contract revenues	58,297	50,486	46,397	45,283	41,395
Costs of net sales and contract revenues:					
Cost of net sales (a)	19,829	16,493	15,925	12,758	9,366
Cost of contract revenues (a)	14,460	12,600	13,789	14,712	15,110
Gross profit	24,008	21,393	16,683	17,813	16,919
Operating expenses:					
Selling, general and administrative (a)	16,094	15,362	21,027	12,844	14,105
Research and development (a)	4,030	5,217	6,236	3,923	3,908
Amortization of intangible assets	147	147	114		
Deferred compensation expense (benefit)	(91 )	48	(484 )	868	
Disposal of fixed assets			422		
Acquired in-process research and development			140		
Total operating expenses	20,180	20,774	27,455	17,635	18,013
Operating income (loss)	3,828	619	(10,772 )	178	(1,094 )
Non-operating income (expense):					
Other income (expense), net	(653 )	35	1,054	1,003	417
Interest expense, net	(1,600 )	(1,459 )	(1,178 )	(123 )	(761 )
Income (loss) from continuing operations before income taxes and minority interest	1,575	(805 )	(10,896 )	1,058	(1,438 )
Income tax benefit (provision)	1,343	885	94	(100 )	
Minority interest in earnings of subsidiary			(526 )	(2,813 )	(3,818 )
Income (loss) from continuing operations	2,918	80	(11,328 )	(1,855 )	(5,256 )
Income (loss) from discontinued operations, net of taxes				1,215	(7,892 )
Net income (loss)	\$ 2,918	\$ 80	\$ (11,328 )	\$ (640 )	\$ (13,148 )
Basic earnings (loss) per share:					
Continuing operations	\$ 0.10	\$ 0.00	\$ (0.45 )	\$ (0.09 )	\$ (0.37 )
Discontinued operations				0.06	(0.55 )
Basic earnings (loss) per share	\$ 0.10	\$ 0.00	\$ (0.45 )	\$ (0.03 )	\$ (0.92 )
Diluted earnings (loss) per share:					
Continuing operations	\$ 0.09	\$ 0.00	\$ (0.45 )	\$ (0.09 )	\$ (0.37 )
Discontinued operations				0.06	(0.55 )
Diluted earnings (loss) per share	\$ 0.09	\$ 0.00	\$ (0.45 )	\$ (0.03 )	\$ (0.92 )
Shares used in calculating basic earnings (loss) per share	29,698	28,182	25,284	19,454	14,276
Shares used in calculating diluted earnings (loss) per share	33,348	32,737	25,284	19,454	14,276

(a) Includes stock-based compensation expense  
as follows:

Cost of net sales	\$ 13	\$ 27	\$ 280	\$	\$
Cost of contract revenues	60	205	2,391		
Selling, general and administrative expense	195	364	7,063		
Research and development expense	20	129	2,043		
Total stock-based compensation expense	\$ 288	\$ 725	\$ 11,777	\$	\$

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	At March 31, 2007 (in thousands)	2006	2005	2004	2003
<b>Consolidated Balance Sheet Data:</b>					
Working capital	\$ 6,979	\$ 3,009	\$ 2,197	\$ 9,369	\$ 3,368
Total assets	55,250	49,633	46,656	30,065	34,842
Long-term debt (less current portion)	9,760	11,374	10,315	891	1,265
Accumulated deficit	(107,438 )	(110,356 )	(110,436 )	(99,108 )	(98,468 )
Total stockholders' equity (deficit)	25,687	18,635	17,462	(1,076 )	(5,340 )

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following discussion and analysis in conjunction with our Consolidated Financial Statements and related Notes thereto included in Part IV, Item 15 of this report and the Risk Factors section in Item 1A, as well as other cautionary statements and risks described elsewhere in this report, before deciding to purchase, hold or sell our common stock.*

### Overview

We are a leading provider of outdoor machine vision systems and sensors that optimize the flow of traffic and enhance driver safety. Using our proprietary software and ITS industry expertise, we provide video sensor systems, transportation management and traveler information systems and other engineering and consulting services to the ITS industry. We use our outdoor image recognition software expertise to develop proprietary algorithms for video sensor systems that improve vehicle safety and the flow of traffic. Using our knowledge of the ITS industry, we design and implement transportation management systems that help public agencies reduce traffic congestion and provide greater access to traveler information.

Our Vantage product is a video vehicle sensing system that detects the presence of vehicles on roadways. Vantage systems are used at signalized intersections to enable a more efficient allocation of green signal time and are also used for incident detection and highway traffic data collection applications. We sell and distribute our Vantage products primarily to commercial customers and municipal agencies.

Our AutoVue LDW systems consist of a small windshield mounted sensor that uses proprietary software to detect and warn drivers of unintended lane departures. Approximately 83,000 production AutoVue LDW units have been sold for truck and car platforms in the North American, European markets and Asian markets. Our AutoVue LDW systems are currently offered as an option on certain Mercedes-Benz, MAN, Iveco, DAF, Scania, International and Freightliner trucks. In Japan, our LDW system is a standard feature on certain FUSO heavy truck models. We provide an aftermarket kit to service the growing number of heavy truck fleet customers in North America. Using our aftermarket kit, our LDW systems can be installed on a variety of heavy trucks such as Freightliner, Volvo, Kennworth, Peterbilt, International and Mack. In September 2003, we entered into an agreement with Valeo, pursuant to which we granted Valeo the exclusive right to sell and manufacture our AutoVue LDW systems to the worldwide passenger car market in exchange for royalty payments for each AutoVue LDW unit sold. To date, royalty payments from Valeo have totaled approximately \$484,000. Pursuant to this agreement, we also generate revenues from Valeo by providing specific contract engineering services, technical marketing and sales support to Valeo related to passenger car development activities and to enable the launch of our LDW on certain Infiniti vehicles. Valeo is currently in discussions to provide our LDW system to other passenger car OEMs; however, we cannot assure you that such discussions will be successful. We plan to continue to provide technical marketing and sales support to Valeo in our efforts to win new OEM customers for the passenger car market, as well as contract engineering services related to the possible launch of new Infiniti platforms that include our LDW system. We believe that AutoVue is a broad sensor platform that, through additional software development, may be expanded to incorporate additional safety and convenience features.

Our transportation management systems business includes transportation engineering and consulting services focused on the planning, design, development and implementation of software-based systems that integrate sensors, video surveillance, computers and advanced communications equipment to enable public agencies to monitor, control and direct traffic flow, assist in the quick dispatch of emergency crews and distribute real-time information about traffic conditions. Our services include planning, design and implementation of surface transportation infrastructure systems. We perform analysis and study goods movement, commercial vehicle operations, travel demand forecasting and systems engineering and identify mitigation measures to reduce traffic congestion. These services and systems are primarily sold to local, state and national transportation agencies in the United States. Our transportation management systems business is largely dependent upon governmental funding and budgetary issues. The Federal Highway Bill that was passed in August 2005 provided for a significant increase in transportation funding over the following six years. The recent growth in our transportation management systems business and our Vantage product business has been enabled in part by this bill, as well as by state transportation bonds such as the \$20 billion infrastructure bond passed in California in November 2006. Historically, there have been significant delays between the passage of funding bills and the allocation of related funding to specific contracts. Accordingly, while we have seen an increase in activity following the passage of the Federal Highway Bill, we cannot currently predict the full impact that this bill or state bonds will have on our transportation management systems business. We anticipate that the success of our transportation systems business will continue to be dependent in part on government spending and the budgetary process.

We have historically operated multiple business units. During the fiscal year ended March 31, 2003 ( Fiscal 2003 ), we operated in three segments consisting of ITS, video products, and telecom products. The ITS segment consisted of our current operations, which was previously conducted by the Iteris Subsidiary. The video products segment consisted of our former wholly-owned subsidiaries, MAXxess Systems, Inc. ( MAXxess, previously known as Gyyr Incorporated), which designed and manufactured security management systems, and Broadcast, Inc. ( Broadcast ), which developed and supplied software based systems to automate and control the multiple classes of equipment used in broadcast studios and satellite uplink facilities. Our telecom segment consisted of our wholly-owned subsidiary, Zyfer, Inc. ( Zyfer ), which developed and manufactured timing and synchronization products and which, prior to its incorporation, was operated as our Communications division.

Beginning in Fiscal 2003, we divested of certain of our business units in order to reduce our operating expenses and to focus on the operations of our Iteris Subsidiary. These divestitures and related restructuring activities included the following transactions:

- In March 2003, we ceased the development and sale of any new Broadcast products, and in September 2003, we sold the balance of our Broadcast business.
- In May 2003, we sold the assets of Zyfer for a purchase price of \$2.3 million in cash and the assumption of liabilities, plus incentive payments based on the revenues generated by the sale of Zyfer's products or the license of its technologies through April 2005. In October 2004, we received an incentive payment of \$135,000 related to the twelve month period ended April 30, 2004, and in September 2005, we received an incentive payment of \$83,000 related to the twelve month period ended April 30, 2005.
- In September 2003, we sold substantially all of the assets of MAXxess to an investor group that included one of our directors and certain members of the MAXxess management group. The consideration for the sale consisted of the assumption of \$2.7 million of liabilities, resulting in a net gain of \$2.3 million on this sale. Subsequent to the sale, in 2005, another member of our Board of Directors became the CEO of MAXxess. We currently sublease to MAXxess 10,000 square feet of space in our Anaheim facility. The sublease will terminate in September 2007 concurrently with the termination of the master lease for our Anaheim facility.
- In May 2004, we repurchased all of the outstanding shares of Series A preferred stock of the Iteris Subsidiary for an aggregate purchase price of approximately \$17.5 million in cash, and we purchased 548,000 shares of the Iteris Subsidiary common stock from DaimlerChrysler Ventures GmbH ( DCV ) in consideration for the issuance of 1.2 million shares of our common stock. We financed the purchase price for the Iteris Subsidiary Series A preferred stock through the issuance of convertible debentures in the original principal amount of \$10.1 million, a \$5.0 million term note payable to our bank and \$2.4 million in cash.
- In June 2004, we issued 2.6 million shares of our common stock valued at \$8.6 million at the date of issuance in exchange for an aggregate of 1.3 million shares of common stock of the Iteris Subsidiary, which had the effect of reducing the residual minority interest in our Iteris Subsidiary to 8.1%.
- In October 2004, we merged the Iteris Subsidiary into us and the remaining minority interest in the Iteris Subsidiary (consisting of 1.2 million shares of common stock of the Iteris Subsidiary) was converted to 2.5 million shares of our common stock valued at \$7.6 million at the merger date. Immediately following the merger, we converted all of our outstanding Class B common stock (922,000 shares) into 1.0 million shares of our common stock (which was formerly designated as Class A common stock). In connection with this merger, we also assumed options and warrants to purchase an aggregate of 3.1 million and 327,000 shares, respectively, of the common stock of the Iteris Subsidiary, which became options and warrants to purchase an aggregate of 6.1 million and 654,000 shares, respectively, of our common stock.
- In October 2004, we amended our certificate of incorporation to (a) change the voting rights of our Class A common stock from one-tenth to one vote per share, (b) remove the ability to issue any further shares of Class B common stock, and (c) rename our Class A common stock to common stock. As a result, we currently have only one

class of capital stock outstanding, the common stock.

Our financial statements for all periods presented in this report have been restated to reflect the discontinuation of the operations of Broadcast, Zyfer and MAXxess.

We currently operate in three reportable segments: Roadway Sensors, Automotive Sensors and Transportation Systems. The Roadway Sensors segment includes our Vantage vehicle detection systems for traffic intersection control,

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incident detection and certain highway traffic data collection applications. The Automotive Sensors segment is comprised of all activities related to our AutoVue LDW systems for vehicle safety. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry.

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our consolidated financial statements included herein, which have been prepared in accordance with generally accepted accounting principles in the United States ( GAAP ). The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the collectibility of accounts receivable, the valuation of inventories, the recoverability of long-lived assets and goodwill, the realizability of deferred tax assets, accounting for stock-based compensation, the valuation of equity instruments, warranty reserves and other contingencies. We base these estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. These estimates and assumptions by their nature involve risks and uncertainties, and may prove to be inaccurate. In the event that any of our estimates or assumptions are inaccurate in any material respect, it could have a material adverse effect on our reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

The following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

*Revenue Recognition.* We record product revenues and related costs of sales upon transfer of title, which is generally upon shipment or, if required, upon acceptance by the customer, provided that we believe collectibility of the net sales amount is reasonably assured. Accordingly, at the date revenue is recognized, the significant uncertainties concerning the sale have been resolved.

Contract revenues are derived primarily from long-term contracts with governmental agencies. Contract revenues include costs incurred plus a portion of estimated fees or profits determined using the percentage of completion method of accounting based on the relationship of costs incurred to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to recognized costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured.

In addition to product and contract revenues, we derive revenue from technology access fees, the provision of specific non-recurring contract engineering services related to our AutoVue LDW systems, and royalties related to unit sales of our AutoVue LDW systems by our strategic partner Valeo to the passenger car market. Technology access fee revenues are recognized evenly over the period in which they are earned. Non-recurring contract engineering revenues are recognized in the period in which the related services are performed. Royalty revenues are recorded based on unit sales of our products by Valeo and are recognized in the period in which such sales occur. Technology access fee revenues, contract engineering revenues and royalty revenues are included in net sales.

Revenues from follow-on service and support, for which we generally charge separately, are recorded in the period in which the services are performed.

*Accounts Receivable.* We estimate the collectibility of customer receivables on an ongoing basis by periodically reviewing invoices outstanding greater than a certain period of time. We record reserves for receivables deemed to be at risk for collection as well as a general reserve based on our historical collections experience. A considerable amount of judgment is required in assessing the ultimate realization of trade receivables, including the current credit-worthiness of each customer. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make required payments, additional allowances may be required that could adversely affect our operating results.



*Inventory.* Inventories consist of finished goods, work-in-process and raw materials and are stated at the lower of cost or market. We provide reserves for potentially excess and obsolete inventory. In assessing the ultimate realization of inventories, we make judgments as to future demand requirements and compare that with the current or committed inventory levels. Reserves are established for inventory levels that exceed anticipated future demand. It is possible that reserves over and above those already established may be required in the future if market conditions for our products deteriorate.

*Goodwill.* Goodwill is tested for impairment annually in our fourth fiscal quarter at the reporting unit level unless a change in circumstances indicates that more frequent impairment analysis is required. Impairment, if any, is measured based on the estimated fair value of the reporting units with the recorded goodwill. Fair value is determined by using the income approach methodology of valuation which utilizes discounted cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the discounted cash flow method of valuation. In estimating future cash flows, we generally use the financial assumptions in our current budget and our current strategic plan, subject to modification as considered necessary, including sales and expense growth rates and the discount rates we estimate to represent our cost of funds. It is possible, however, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of goodwill, we could incur impairment charges.

*Warranty.* We generally provide a one to three year warranty from the original invoice date on all products, materials and workmanship. Defective products are either repaired or replaced, at our option, upon meeting certain criteria. We accrue a provision for the estimated costs that may be incurred for product warranties relating to a product as a component of cost of sales at the time revenue for that product is recognized. The accrued warranty provision is included within accrued expenses on the accompanying consolidated balance sheets. Should our actual experience of warranty returns be higher than anticipated, additional warranty reserves may be required, which may adversely affect our operating results.

*Taxes.* We recorded a valuation allowance to reduce our deferred tax assets to amounts that we believe are more likely than not to be realized. Realization of deferred tax assets (such as net operating loss carryforwards) is dependent on future taxable earnings and is therefore uncertain. On a quarterly basis, we assess the likelihood that our deferred tax asset balance will be recovered from future taxable income. To the extent we believe that recovery is not likely, we establish a valuation allowance against our deferred tax asset, increasing our income tax expense in the period such determination is made.

On an interim basis, we estimate what our anticipated annual effective tax rate will be and record a quarterly income tax provision in accordance with this anticipated rate. As the fiscal year progresses, we refine our estimates based upon actual events and earnings during the year. This estimation process can result in significant changes to our expected effective tax rate. When this occurs, we adjust the income tax provision during the quarter in which the change in estimate occurs so that the year-to-date provision reflects the expected annual rate. The changes described in the preceding sentence and adjustments to our valuation allowance may create fluctuations in our overall effective tax rate from quarter to quarter.

*Stock-Based Compensation.* We adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ), effective April 1, 2006. Prior to April 1, 2006, we followed the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, and, accordingly, accounted for our stock-based compensation plans using the intrinsic value method under Accounting Principles Board Opinion No. 25 ( APB 25 ) and related interpretations.

SFAS 123R requires all stock-based payments, including grants of employee stock options, to be recognized in the statement of operations as an expense, based on their grant date fair values with such fair values amortized over the requisite service period. We elected to utilize the modified prospective method for the transition to SFAS 123R. Under the modified prospective method, SFAS 123R applies to all awards granted or modified after the date of adoption. In addition, under the modified prospective method, compensation expense will be recognized for

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all stock-based compensation awards granted prior to but not yet vested as of April 1, 2006, based on grant-date fair values estimated in accordance with the original provisions of SFAS 123.

In implementing SFAS 123R, we have used the Black-Scholes-Merton ( BSM ) option-pricing formula to estimate the fair value of stock-based awards granted subsequent to April 1, 2006. Our assumptions under the BSM formula include the following: expected volatilities are based on the historical volatility of our stock price, the expected life of options is derived based on the historical life of our options, and the risk-free rate for periods within the expected life of the option is based on the

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U.S. Treasury interest rates in effect at the time of grant. Additionally, SFAS 123 did not require the estimation of forfeitures in the calculation of stock compensation expense; however, SFAS 123R does require such estimation and upon adoption of SFAS 123R, we changed our methodology to include an estimate of forfeitures. Future stock-based compensation expense in any particular quarter or year could be affected by changes in our assumptions or changes in market conditions.

### Results of Operations

The following table sets forth certain statement of operations data as a percentage of total net sales and contract revenues for the periods indicated. The following table should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations.

	Fiscal Year Ended March 31,					
	2007		2006		2005	
<b>Net sales and contract revenues:</b>						
Net sales	62.2	%	61.7	%	62.6	%
Contract revenues	37.8		38.3		37.4	
Total net sales and contract revenues	100.0	%	100.0	%	100.0	%
<b>Costs of net sales and contract revenues:</b>						
Cost of net sales (a)	34.0		32.7		34.3	
Cost of contract revenues (a)	24.8		24.9		29.7	
Gross profit	41.2		42.4		36.0	
<b>Operating expenses:</b>						
Selling, general and administrative (a)	27.6		30.4		45.3	
Research and development (a)	6.9		10.3		13.4	
Amortization of intangible assets	0.3		0.3		0.2	
Deferred compensation expense (benefit)	(0.2)	)	0.1		(1.0)	)
Disposal of fixed assets					0.9	
Acquired in-process research and development					0.3	
Total operating expenses	34.6		41.1		59.2	
Operating income (loss)	6.6		1.2		(23.2)	)
<b>Non-operating income (expense):</b>						
Other income (expense), net	(1.1)	)	0.1		2.2	
Interest expense, net	(2.7)	)	(2.9)	)	(2.5)	)
Income (loss) before income taxes and minority interest	2.7		(1.6)	)	(23.5)	)
Income tax benefit	2.3		1.8		0.2	
Minority interest in earnings of subsidiary					(1.1)	)
Net income (loss)	5.0	%	0.2	%	(24.4)	)%

(a) Includes stock-based compensation expense as a percent of total net sales and contract revenues as follows:

Cost of net sales	0.0	%	0.1	%	0.6	%
Cost of contract revenues	0.1		0.4		5.2	
Selling, general and administrative expense	0.3		0.7		15.2	
Research and development expense	0.0		0.3		4.4	
Total stock-based compensation expense	0.5	%	1.4	%	25.4	%

### Years Ended March 31, 2007, 2006 and 2005

*Net Sales and Contract Revenues.* Net sales are comprised of Roadway Sensors sales, which are derived from sales of our Vantage video detection systems, and Automotive Sensors sales, which are derived from sales of AutoVue LDW systems, technology access fees, contract engineering revenue and royalty revenue generated from AutoVue related activities. Contract revenues consist entirely of Transportation Systems contract revenues, which are generated from

systems integration and ITS consulting services with federal, state, county and municipal agencies. We currently have a diverse customer base with our

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largest customer constituting 12.4% of total net sales and contract revenues in Fiscal 2007. Total net sales and contract revenues increased 15.5% to \$58.3 million in Fiscal 2007 compared to \$50.5 million in Fiscal 2006, and increased 8.8% in Fiscal 2006 from \$46.4 million in Fiscal 2005.

Net sales increased 16.3% to \$36.2 million in Fiscal 2007 compared to \$31.2 million in Fiscal 2006, and increased 7.2% in Fiscal 2006 compared to \$29.1 million in Fiscal 2005. The increase in net sales in each of the periods reflected increased unit sales in both Roadway Sensors and Automotive Sensors.

Roadway Sensors net sales comprised 75.2%, 72.0% and 75.4% of net sales in Fiscal 2007, Fiscal 2006 and Fiscal 2005, respectively and increased 21.5% to \$27.3 million in Fiscal 2007 compared to \$22.4 million in Fiscal 2006 and increased 2.4% in Fiscal 2006 compared to \$21.9 million in Fiscal 2005. The majority of Roadway Sensors net sales were derived from sales within North America. The Fiscal 2007 increase was primarily due to higher unit sales of Vantage video detection systems, which reflected broader market acceptance of video-based detection technologies and positive reaction to new Vantage product offerings such as color cameras and eAccess, as well as higher governmental spending, which we believe was related to the passage of the Federal Highway Bill in August 2005. The Fiscal 2006 increase was primarily due to increased market adoption of video-based detection technologies for traffic intersection management and our ability to obtain additional contracts with state departments of transportation. In Fiscal 2007, we experienced increased lead times in procuring components, a trend that we expect to continue and which could adversely affect our sales in the future.

Net sales from Automotive Sensors products and services increased 3.2% in Fiscal 2007 to \$9.0 million compared to \$8.7 million in Fiscal 2006 and increased 22.0% in Fiscal 2006 compared to \$7.1 million in Fiscal 2005. The increase in Fiscal 2007 net sales of Automotive Sensors products and services was primarily related to increased unit sales of LDW systems in the North American commercial heavy truck market. While overall unit sales of our AutoVue LDW systems increased in Fiscal 2007, Automotive Sensors net sales were negatively affected by OEM volume discounts provided to our largest customer and the impact of the transition to our next generation AutoVue LDW systems for the heavy truck market in the latter part of Fiscal 2006. The Fiscal 2006 increase in Automotive Sensors net sales was largely due to increased LDW unit sales in the European and North American commercial heavy truck markets, which increased 35.6% in Fiscal 2006 compared to Fiscal 2005. Although we have seen increased unit sales of AutoVue LDW systems in recent fiscal years, Automotive Sensors unit sales in Fiscal 2008 could be adversely impacted by slower than expected adoption rates of our LDW system by European and Asian OEMs and North American heavy truck fleets, as well as potential additional OEM volume discounts. Additionally, recent environmental regulations in Europe and North America have substantially increased the cost of new commercial trucks, which could impact future truck sales volumes and, ultimately, unit sales of our LDW systems.

Royalty revenues from Valeo for sales of our LDW systems for the passenger car market remained relatively insignificant in Fiscal 2007. Our LDW systems are now offered as an option on three Infiniti models. While Valeo is currently in discussions to offer our LDW systems on other passenger car platforms, we cannot assure you that Valeo will be successful in these efforts.

Contract revenues increased 14.1% to \$22.0 million in Fiscal 2007 compared to \$19.3 million in Fiscal 2006, and increased 11.5% in Fiscal 2006 compared to \$17.3 million in Fiscal 2005. Contract revenues reflect a broad range of fixed price and cost plus fixed fee contracts for engineering study and design, systems integration and system implementation. All of our contract revenue is currently derived from work performed in North America. Contract revenues are dependent upon the continued availability of funding at both the state and federal levels from the various departments of transportation. We believe the increase in Fiscal 2007 contract revenues compared to Fiscal 2006 and Fiscal 2006 compared to Fiscal 2005 was largely the result of the passage of the Federal Highway Bill in August 2005, as well as increased spending at the state and local levels. The increase in contract revenues in Fiscal 2007 was also due to continued growth in the California market and stronger sales in the Eastern U.S. market. In response to the growth in our Transportation Systems segment, we have increased our Transportation Systems staff by 16% in Fiscal 2007. We expect to continue to increase our Transportation Systems staff over the next fiscal year. We believe the ability of our Transportation Systems business to grow and successfully win and service new contracts will be highly dependent upon our continued success in recruiting and retaining qualified personnel.

*Gross Profit.* Total gross profit increased 12.2% to \$24.0 million in Fiscal 2007 compared to \$21.4 million in Fiscal 2006, and increased 28.2% in Fiscal 2006 compared to \$16.7 million in Fiscal 2005. Total gross profit as a percent of net sales and contract revenues decreased to 41.2% in Fiscal 2007 compared to 42.4% in Fiscal 2006 and increased in Fiscal 2006 from 36.0% in Fiscal 2005.

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Gross profit as a percentage of net sales was 45.3% in Fiscal 2007 compared to 47.1% in Fiscal 2006 and 45.2% in Fiscal 2005. The 180 basis point decrease in gross profit in Fiscal 2007 compared to Fiscal 2006 was primarily due to volume discounts given to our largest Automotive Sensors hardware customer as well as an overall decline in unit volumes to this customer. Fiscal 2007 gross profit as a percentage of net sales in our Roadway Sensors division were relatively consistent with Fiscal 2006 gross profit as a percentage of net sales. We limit quantitative discussion of gross profit for our Roadway Sensors and Automotive Sensors segments for competitive reasons. Gross profit as a percentage of net sales can fluctuate in any specific quarter or year based on customer mix and volume discounts given, as well as possible shifts of engineering resources from development activities to sustaining activities which we record as cost of goods sold. Gross profit as a percent of net sales has fluctuated over the last five years from a high of 51.0% in Fiscal 2003 to a low of 45.2% in Fiscal 2005.

The 190 basis point increase in gross profit in Fiscal 2006 compared to Fiscal 2005 was primarily a result of increased margins on Roadway Sensors products due to product improvements aimed at reducing the cost of goods sold, production efficiencies as a result of higher unit sales and a change in our Roadway Sensors business model in California to a direct sales model. Additionally, Fiscal 2005 cost of net sales included \$280,000 of stock based compensation compared to \$27,000 in Fiscal 2006.

Gross profit as a percentage of contract revenues decreased to 34.4% in Fiscal 2007 compared to 34.8% in Fiscal 2006 and increased from 20.5% in Fiscal 2005. We recognize contract revenues and related gross profit using percentage of completion contract accounting and the underlying mix of contract activity affects the related gross profit recognized in any given period. The decrease in gross profit as a percent of contract revenues in Fiscal 2007 compared to Fiscal 2006 reflects a contract mix weighted more toward lower margin contracts in the period. The increase in Fiscal 2006 from Fiscal 2005 was largely a result of the inclusion of \$2.4 million of stock-based compensation in the cost of contract revenues in Fiscal 2005 compared to \$205,000 in Fiscal 2006. By comparison, \$60,000 of stock-based compensation was included in Fiscal 2007 cost of contract revenues.

*Selling, General and Administrative Expense.* Selling, general and administrative expense increased 4.8% to \$16.1 million (or 27.6% of total net sales and contract revenues) in Fiscal 2007 compared to \$15.4 million (or 30.4% of total net sales and contract revenues) in Fiscal 2006, and decreased 26.9% in Fiscal 2006 compared to \$21.0 million (or 45.3% of total net sales and contract revenues) in Fiscal 2005. The increase in selling, general and administrative expense in Fiscal 2007 compared to Fiscal 2006 was mainly a result of higher commissions associated with increased Roadway Sensors net sales and increased sales and marketing activities in our Transportation Systems segment. Additionally, selling, general and administrative expense included legal expenses associated with the settlement of litigation described in Note 7 to the accompanying consolidated financial statements, a severance accrual of approximately \$300,000 associated with the departure of our former Chief Executive Officer in March 2007 and \$180,000 related to the write-off of past-due accounts receivable related to rent and other services provided to our former subsidiary, MAXxess. No further expense is expected to be incurred in connection with the aforementioned lawsuit or the severance arrangement with our former Chief Executive Officer. Severance payments to our former Chief Executive Officer will be made over a one year period. We have written off all balances receivable from MAXxess based on our accounts receivable accounting policy and will continue to work with MAXxess to collect amounts due to us. Certain members of our Board of Directors are part of MAXxess management and ownership. In the coming quarters, we anticipate increased selling, general and administrative expense related to our efforts to comply with the internal control attestation requirements of the Sarbanes-Oxley Act, with which we must begin to comply in April 2007.

The decrease in selling, general and administrative expense in Fiscal 2006 compared to Fiscal 2005 was largely a result of a \$7.1 million charge for stock-based compensation incurred in Fiscal 2005, compared to stock-based compensation expense of \$364,000 in Fiscal 2006; additional accounting and legal fees incurred in the first and second quarter of Fiscal 2006 related to a change in audit firms; costs incurred in anticipation of compliance with the Sarbanes-Oxley Act of 2002; additional common area charges incurred in connection with our Anaheim headquarters; and increased outside sales commissions in our Roadway Sensors business.

*Research and Development Expense.* Research and development expense decreased 22.8% to \$4.0 million (or 6.9% of total net sales and contract revenues) in Fiscal 2007 compared to \$5.2 million (or 10.3% of total net sales and contract revenues) in Fiscal 2006, and decreased 16.3% in Fiscal 2006 compared to \$6.2 million (or 13.4% of total net sales and contract revenues) in Fiscal 2005. The decrease in research and development expense in Fiscal 2007 compared to Fiscal 2006 was largely a result of higher than anticipated costs in the prior year period in Automotive Sensors as we expended significant development resources in qualifying the next generation LDW system with our largest customer, as well as several other heavy





truck OEMs. Additionally, in Fiscal 2007, there was a shift in engineering resources from research and development activities to product support activities as a result of new product introductions and improvements in Roadway Sensors. Costs associated with product support activities are included in cost of net sales rather than research and development expense. We plan to introduce several key products in our Roadway Sensors division in Fiscal 2008 and expect research and development expenses to increase slightly from Fiscal 2007 levels.

The decrease in research and development expense in Fiscal 2006 compared to Fiscal 2005 was mainly a result of \$2.0 million of stock-based compensation charged to research and development expense in Fiscal 2005 compared to stock-based compensation of \$129,000 in Fiscal 2006. This effect was offset by increased spending in Fiscal 2006 for both our Vantage video detection products and our AutoVue LDW system for the heavy truck market. Additional development funds were allocated to the Roadway Sensors business in Fiscal 2006 to complete the development of new products that were introduced in Fiscal 2007, refresh the existing product line and enhance cost reduction activities. Additional funds allocated to the Automotive Sensors business were primarily used to develop and qualify the next generation AutoVue LDW system for the heavy truck market in Europe and North America.

For competitive reasons, we closely guard the confidentiality of specific development projects.

*Deferred Compensation Expense (Benefit).* Deferred compensation expense (benefit) represents changes in the fair value of assets, primarily shares of our common stock, held by our deferred compensation savings plan under which certain senior executives may defer compensation. Prior to the merger of the Iteris Subsidiary into us in Fiscal 2005, the plan held shares of Iteris Subsidiary common stock. In connection with the Fiscal 2005 merger of the Iteris Subsidiary into us, shares of Iteris Subsidiary common stock held by the plan were exchanged for shares of our common stock. Changes in the value of common stock held by the plan resulted in a benefit of \$91,000 in Fiscal 2007, expense of \$48,000 in Fiscal 2006 and a benefit of \$484,000 in Fiscal 2005. No compensation was deferred into the plan in Fiscal 2007, Fiscal 2006 and Fiscal 2005.

*Other Income (Expense), Net.* Other income (expense), net reflects the following:

	Year Ended March 31, 2007 (In thousands)	2006	2005
Settlement of lawsuits	\$ (635 )	\$	\$ 949
Other	(18 )	35	105
Other income (expense), net	\$ (653 )	\$ 35	\$ 1,054

**Other income (expense), net in Fiscal 2007 primarily reflects \$635,000 of expense recorded in connection with the settlement of litigation in July 2006. Other income (expense), net in Fiscal 2005 primarily reflects a \$949,000 gain recognized on the settlement of litigation in which we were a beneficiary of, but not a party to, litigation between Rockwell International and the Michigan Department of Transportation. Refer to Note 7 to the accompanying consolidated financial statements for further discussion of these settlements.**

*Interest Expense, Net.* Interest expense, net reflects the net of interest expense and interest income as follows:

	Year Ended March 31, 2007 (In thousands)	2006	2005
Interest expense	\$ (1,601 )	\$ (1,461 )	\$ (1,180 )
Interest income	1	2	2
Interest expense, net	\$ (1,600 )	\$ (1,459 )	\$ (1,178 )

**Interest expense, net increased 9.7% in Fiscal 2007 compared to Fiscal 2006 and increased 23.9% in Fiscal 2006 compared to Fiscal 2005. The increase in interest expense in Fiscal 2007 compared to Fiscal 2006 was mainly related to the October 2006 banking change, in which we refinanced our existing term note and line of credit with a new bank. In connection with this refinancing, we also increased our credit facility by \$3.0 million from \$5.0 million to \$8.0 million, which resulted in slightly higher interest costs in Fiscal 2007 as compared to Fiscal 2006. The increase in interest expense, net in Fiscal 2006 as compared to Fiscal 2005 was mainly related to an increase in the interest rate on our line of credit and term note as well as increased average borrowings on our line of credit.**



*Income Taxes.* During Fiscal 2007, we recognized an income tax benefit of \$1.3 million and at March 31, 2007, our consolidated balance sheet included net deferred tax assets of \$3.0 million. The ability to record the deferred tax asset was based on the more likely than not criteria of Statement of Financial Accounting Standards ( SFAS ) No. 109, *Accounting for Income Taxes*. During Fiscal 2006, we recognized an income tax benefit of \$885,000, and at March 31, 2006, our consolidated balance sheet included net deferred tax assets of \$1.6 million.

At March 31, 2007, we had \$49.3 million of federal net operating loss carryforwards and \$22.4 million of state net operating loss carryforwards that begin to expire in 2019 and 2008, respectively. Due to changes in stock ownership, our federal net operating loss carryforwards are subject to a Section 382 limitation estimated at approximately \$2.9 million annually which can be utilized to offset federal consolidated taxable income.

Although the impact cannot be precisely determined, we believe that our net operating loss carryforwards and the valuation allowance we have recorded against our net deferred tax assets in our consolidated balance sheets will cause us to have future income tax payments and income tax expense that are substantially lower than the income tax liability and income tax expense calculated using statutory tax rates.

*Minority Interest in Earnings of Subsidiary.* Minority interest in earnings of subsidiary represents the minority stockholders share of the Iteris Subsidiary s net income (loss) combined with the accretion of the redemption preference of the Iteris Subsidiary s Series A preferred stock. On October 22, 2004, we completed the merger of the Iteris Subsidiary into us. As a result of the completion of the merger in October 2004, we did not incur any charge for minority interest subsequent to that date. No future charges for minority interest are anticipated.

*Stock-Based Compensation Expense.* In Fiscal 2007, we adopted SFAS 123R using the modified prospective approach. Stock-based compensation expense was \$288,000 in Fiscal 2007. See Notes 1 and 10 to the accompanying consolidated financial statements for additional discussion regarding our implementation of SFAS 123R.

As discussed above and in the Overview to Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 3 to the accompanying consolidated financial statements, on October 22, 2004, we completed the merger of the Iteris Subsidiary into us. Upon completion of the merger, we recorded \$11.3 million of stock-based compensation expense related to the assumption and exchange of vested stock options assumed in the merger. Additionally, stock-based compensation expense was recorded subsequent to the merger date based on the vesting schedule of stock options that were not yet vested on the merger date. This resulted in stock-based compensation expense of \$725,000 and \$11.8 million in Fiscal 2006 and Fiscal 2005, respectively. No additional stock-based compensation expense is expected to be recognized in connection with stock options assumed in the merger.

## **Liquidity and Capital Resources**

### *Cash Flows*

We have historically financed our operations with a combination of cash flows from operations, borrowings under credit facilities and the sale of equity securities. We currently rely on cash flows from operations and borrowings on a line of credit facility to fund our operations, which we believe to be sufficient to fund our operations for at least the next twelve months. However, should a shortfall occur, we believe we could obtain additional funds through additional borrowings or the sale of equity securities. At March 31, 2007, we had \$7.0 million in working capital, which included borrowings of \$4.0 million on our revolving line of credit and \$35,000 in cash and cash equivalents. This compares to working capital of \$3.0 million at March 31, 2006, which included borrowings of \$2.7 million on our revolving line of credit and \$131,000 in cash and cash equivalents. Our operations used \$2.0 million of cash during Fiscal 2007, primarily as a result of investments in inventory due to sales growth and longer lead times in procuring certain components, and an increased level of net costs and estimated earnings in excess of billings due to sales growth and the timing of invoicing on contracts in our Transportation Systems segment. These were partially offset by net income of \$2.9 million. During Fiscal 2006, our operations provided \$218,000 of cash, primarily as a result of planned decreases in inventory and the timing of payments on accrued expenses and payables, which were partially offset by increases in accounts receivable and net costs and estimated earnings in excess of billings on uncompleted contracts, both as a result of sales growth. We generated \$590,000 in cash from operations in Fiscal 2005, primarily due to the receipt of \$949,000 related to a legal settlement between Rockwell International and the Michigan Department of Transportation, to which we were a third party beneficiary.



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Investing activities for Fiscal 2007, Fiscal 2006 and Fiscal 2005 consisted primarily of purchases of property and equipment, which aggregated \$488,000, \$1.3 million and \$670,000, respectively. In Fiscal 2006, capital expenditures increased significantly primarily due to hardware, software and related labor costs to implement a new enterprise resource management system, which was put into use at the beginning of Fiscal 2007.

Cash provided by financing activities was \$2.4 million in Fiscal 2007, which was the net result of net payments on borrowings of \$1.2 million offset by cash inflows of \$3.6 million from the exercise of outstanding stock options and warrants to purchase our common stock. As discussed in Note 9 to the accompanying consolidated financial statements, approximately \$2.0 million of the \$3.6 million in proceeds from the exercise of stock options and warrants was raised through the exercise of outstanding warrants to purchase an aggregate of 1,250,000 shares of our common stock. During Fiscal 2006, financing activities provided \$1.1 million of cash as a result of net borrowings of \$792,000 and cash inflows of \$333,000 from the exercise of outstanding stock options and warrants to purchase our common stock. During Fiscal 2005, financing activities used \$2.5 million of cash, which was comprised of net cash outflows of approximately \$3.1 million related to the merger activities described more fully above in the Overview to Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 3 to the accompanying consolidated financial statements, partially offset by \$501,000 in proceeds from the exercise of stock options and warrants to purchase our common stock.

### *Borrowings*

The following table summarizes our borrowings and long-term debt:

	<b>At March 31, 2007</b> <b>(In thousands)</b>
Revolving line of credit	\$ 4,015
Convertible debentures, net	9,410
Bank term note	1,573
Promissory note to landlord	646
Other long-term debt	78
	<b>\$ 15,722</b>

In October 2006, we refinanced our existing line of credit and entered into a new two-year credit facility with our new bank. The facility provides for combined line of credit and term note borrowings of up to \$8.0 million. Under the new credit facility, we may borrow against our eligible accounts receivable and eligible inventory, as defined in the credit agreement. Interest on borrowed amounts is payable monthly at the current stated prime rate plus 1.25%. Additionally, we are obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month. The new credit facility requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. Additionally, we paid a commitment fee of \$40,000 in October 2006 and are obligated to pay an additional \$40,000 on the one year anniversary of the facility. The new credit facility is secured by substantially all of our assets. At March 31, 2007, we had \$8.0 million available under our credit facility, of which \$2.4 million was unused.

We believe that the cash generated from our operations, together with our new credit facility, will be sufficient to fund our operations for at least the next twelve months. However, should a shortfall occur, we may need to raise additional funds through other debt financings or the sale of equity securities.

### **Contractual Obligations**

Our contractual obligations are as follows at March 31, 2007:

	<b>Payments Due by Period</b>					<b>Thereafter</b>	<b>Total</b>
	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>		
Lines of credit	\$ 4,015	\$	\$	\$	\$	\$	\$ 4,015
Notes payable	1,947	350					2,297
Convertible debentures			9,850				9,850
Operating leases	1,277	1,398	1,391	1,348	1,332	3,823	10,569
<b>Total</b>	<b>\$ 7,239</b>	<b>\$ 1,748</b>	<b>\$ 11,241</b>	<b>\$ 1,348</b>	<b>\$ 1,332</b>	<b>\$ 3,823</b>	<b>\$ 26,731</b>



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At March 31, 2007, we had firm commitments to purchase inventory in the amount of \$2.6 million during the first and second quarters of Fiscal 2008.

### **Off Balance Sheet Arrangements**

In connection with the restructuring and merger activities described in the Overview to Management's Discussion and Analysis of Financial Condition and Results of Operations and in Notes 3, 5 and 9 to the accompanying consolidated financial statements, in May 2004 we issued subordinated convertible debentures in an aggregate original principal amount of \$10.1 million. These debentures are due in full on May 19, 2009 and are convertible into shares of our common stock at a conversion price of \$3.61 per share. At March 31, 2007, \$9.9 million of these convertible debentures remained outstanding. Because these debentures are conventionally convertible, we have not separately accounted for the conversion feature and, accordingly, no separate amounts are presented in our consolidated financial statements in connection with this conversion feature.

At March 31, 2007, outstanding warrants to purchase 62,500 shares of our common stock at an exercise price of \$1.95 per share and outstanding warrants to purchase an aggregate of 246,250 shares of common stock at an exercise price of \$3.25 per share are callable by us if the market price of our common stock trades for 20 consecutive days at a price equal to or greater than two times the exercise price of the warrants. Outstanding warrants to purchase an aggregate of 75,000 shares of our common stock at an exercise price of \$5.00 per share are callable by us if the market price of our common stock trades for 20 consecutive days at a price equal to or greater than one and a half times the exercise price of the warrants.

In connection with the issuance of warrants to purchase 246,250 shares of our common stock at \$3.25 per share, we are a party to a registration rights agreement that contains provisions under which we could be subjected to liquidated damages should we fail to maintain effective registration statements for the shares of common stock issuable upon exercise of certain underlying warrants. These warrants have been accounted for within equity in our consolidated balance sheet at March 31, 2007 in accordance with EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and, accordingly, no liabilities have been recorded in connection therewith. As of the date of this filing, no liquidated damages are payable under the provisions of the registration rights agreement associated with these warrants.

### **Rule 10b5-1 Trading Plans**

Two of our executive officers, Greg McKhann and Francis Memole, have entered into trading plans pursuant to Rule 10b5-1(c)(1) of the Securities Exchange Act of 1934, as amended, which cover an aggregate of 150,000 shares of our common stock. Abbas Mohaddes terminated his trading plan upon his promotion to Chief Executive Officer in March 2007.

### **Recent Accounting Pronouncements**



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In July 2006, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. We are currently evaluating the impact of FIN 48 and will adopt this Interpretation in the first quarter of our fiscal year ending March 31, 2008.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application of the statement is encouraged. Generally, this statement will be applied prospectively. We are currently evaluating the impact of SFAS 157 and expect to adopt SFAS 157 in the first quarter of our fiscal year ending March 31, 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are evaluating the impact that the adoption of SFAS 159 will have on our results of operations and financial condition and expect to adopt SFAS 159 in our fiscal year ending March 31, 2009.

### Seasonality

We have historically experienced seasonality, particularly with respect to our Roadway Sensors net sales in the third and fourth fiscal quarters due to a reduction in road construction or repairs during the winter months due to inclement weather conditions.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk is limited to our line of credit, bank term note and a promissory note to our landlord. Our line of credit, bank term note and promissory note to our landlord bear interest based on the prevailing prime rate (8.25%)

at March 31, 2007). We do not believe that a 10% increase in the interest rate on our line of credit, bank term note and promissory note to our landlord (from 9.50% to 10.45% on the line of credit, from 9.50% to 10.45% on the bank term note and from 10.25% to 11.28% on the promissory note to our landlord) would have a material impact on our financial position, operating results or cash flows. In addition, we believe that the carrying value of our outstanding debt approximates fair value.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements and supplementary data required by Regulation S-X are included in Part IV, Item 15 of this report.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Our management necessarily applied its judgment in evaluating the cost-benefit relationship of such controls and procedures.

### **Changes in Internal Controls**

During the most recent completed fiscal quarter covered by this report, there has been no change in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Effective April 1, 2006, we implemented a new enterprise resource planning system that we believe has not resulted in any material changes in our internal controls over financial reporting.

## **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

## **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

(a) *Identification of Directors.* The information under the caption Election of Directors, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

(b) *Identification of Executive Officers.* The information under the caption Executive Compensation and Other Information - Executive Officers, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.



(c) *Compliance with Section 16(a) of the Exchange Act.* The information under the caption Section 16(a) Beneficial Ownership Reporting Compliance appearing in our proxy statement for the 2007 Annual Meeting of Stockholders is incorporated herein by reference.

(d) *Corporate Governance.* The information under the caption Corporate Governance, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

(e) *Audit Committee.* The information under the caption Board Meetings and Committees Audit Committee, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information under the caption Executive Compensation and Other Information, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

#### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information under the captions Equity Compensation Plans and Principal Stockholders and Common Stock Ownership of Certain Beneficial Owners and Management, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information under the captions Corporate Governance Director Independence and Certain Transactions, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

#### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information under the caption Fees Paid to Independent Registered Public Accounting Firm, appearing in our proxy statement for the 2007 Annual Meeting of Stockholders, is incorporated herein by reference.

### **PART IV**

#### **ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) Documents filed as part of this report:

1. *Financial Statements.* The following financial statements of Iteris, Inc. are included in a separate section of this Annual Report on Form 10-K commencing on the pages referenced below:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets as of March 31, 2007 and 2006  
Consolidated Statements of Operations for the years ended March 31, 2007, 2006 and 2005  
Consolidated Statements of Stockholders' Equity and Comprehensive Income for the years ended March 31, 2007, 2006 and 2005  
Consolidated Statements of Cash Flows for the years ended March 31, 2007, 2006 and 2005  
Notes to Consolidated Financial Statements

2. *Financial Statement Schedules.*

Schedule II Valuation and Qualifying Accounts

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All other schedules have been omitted because they are not required or the required information is included in our consolidated financial statements and notes thereto.

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### 3. *Exhibits.*

The following exhibits are filed herewith or incorporated by reference to the location indicated below:

Exhibit Number	Description	Where Located
3.1	Amended and Restated Certificate of Incorporation of the registrant	<i>Exhibit 3.1 to the registrant's Current Report on Form 8-K as filed with the SEC on October 28, 2004</i>
3.2	Bylaws of the registrant, as amended	<i>Exhibit 4.2 to the registrant's Registration Statement on Form S-1 (Reg. No. 033-67932) as filed with the SEC on July 6, 1993</i>
3.3	Certificates of Amendment to Bylaws of the registrant dated April 24, 1998 and August 10, 2001	<i>Exhibit 3.4 to the registrant's Annual Report on Form 10-K/A for the year ended March 31, 2003 as filed with the SEC on July 29, 2003</i>
3.4	Certificate of Amendment to Bylaws of registrant dated September 9, 2004	<i>Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 as filed with the SEC on November 15, 2004</i>
3.5	Certificate of Amendment to Bylaws of registrant effective September 16, 2005	<i>Filed Herewith</i>
4.1	Specimen of common stock certificate	<i>Exhibit 4.1 to registrant's Registration Statement on Form 8-A as filed with the SEC on December 8, 2004</i>
4.2	Amended and Restated Rights Agreement, dated as of May 10, 2004, by and between the registrant and U.S. Stock Transfer Corporation, including exhibits thereto	<i>Exhibit 99.1 to the registrant's Registration Statement on Form 8-A/A as filed with the SEC on June 18, 2004</i>
10.1*	Profit Sharing Plan and Trust	<i>Exhibit 10.3 to the registrant's Amendment No. 2 to the Registration Statement on Form S-8 (Reg. No. 002-98656) as filed with the SEC on May 5, 1988</i>
10.2*	Amendment Nos. 3 and 4 to the Profit Sharing Plan and Trust	<i>Exhibits 4.3.1 and 4.3.2, respectively, to Amendment No. 3 to the registrant's Registration Statement on Form S-3 (Reg. No. 002-86220) as filed with the SEC on June 13, 1990</i>
10.3*	Form of Executive Deferral Plan between the registrant and certain employees of the registrant	<i>Exhibit 10.4 to the registrant's Annual Report on Form 10-K for the year ended March 31, 1988</i>
10.4	Form of Indemnity Agreement entered into by the registrant and certain of its officers and directors	<i>Exhibit 19.4 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1988</i>
10.5	Form of Indemnification Agreement entered into by the registrant and certain of its officers and directors	<i>Exhibit 10.5 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2004 as filed with the SEC on June 29, 2004</i>
10.6*	1997 Stock Incentive Plan (as amended on May 3, 2003, as further amended on December 15, 2004)	<i>Exhibit 10.32 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i>
10.7*	Form of Notice of Grant of Stock Option	<i>Exhibit 99.2 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>



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Exhibit Number	Description	Where Located
10.8*	Form of Stock Option Agreement	<i>Exhibit 99.3 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.9*	Form of Addendum to Stock Option Agreement Involuntary Termination Following Corporate Transaction or Change in Control	<i>Exhibit 99.4 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.10*	Form of Addendum to Stock Option Agreement Limited Stock Appreciation Rights	<i>Exhibit 99.5 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.11*	Form of Stock Issuance Agreement	<i>Exhibit 99.6 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.12*	Form of Addendum to Stock Issuance Agreement Involuntary Termination Following Corporate Transaction/Change in Control	<i>Exhibit 99.7 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.13*	Form of Notice of Grant of Automatic Stock Option Initial Grant	<i>Exhibit 99.8 to Exhibit 99.8 to registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.14*	Form of Notice of Grant of Automatic Stock Option Annual Grant	<i>Exhibit 99.9 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 14, 2000</i>
10.15*	Form of Automatic Stock Option Agreement.	<i>Exhibit 99.10 to the registrant's Registration Statement on Form S-8 (File No. 333-30396) as filed with the SEC on February 19, 2000</i>
10.16	Amended and Restated Agreement of Purchase and Sale and Escrow Instructions, dated February 19, 2002, by and between Iteris, Inc. and 1515 South Manchester, LLC	<i>Exhibit 2.1 to the registrant's Current Report on Form 8-K as filed with the SEC on June 12, 2002</i>



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10.17*	Change in Control Agreement dated May 8, 2003 by and between the registrant and Gregory A. Miner	<i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 as filed with the SEC on August 14, 2003</i>
10.18*	Change in Control Agreement dated May 20, 2003 by and between the registrant and Jack E. Johnson	<i>Exhibit 10.23 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 as filed with the SEC on February 17, 2004</i>
10.19*	Iteris Inc. 1998 Stock Incentive Plan (as amended on February 7, 2000)	<i>Exhibit 10.24 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i>
10.20*	Form of Notice of Grant, including forms of Option Agreement and Stock Purchase Agreement for the following directors and executive officers: Gary Hernandez, Dr. Hartmut Marwitz, Paul E. Wright, Jack Johnson, Richard D. Crawshaw, Gregory McKhann, Francis Memole, James S. Miele, Abbas Mohaddes and Stephen Edwin Rowe	<i>Exhibit 99.2 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i>
10.21*	Form of Addendum to Stock Option Agreement	<i>Exhibit 99.3 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i>
10.22*	Form of 1997 Stock Option Agreements	<i>Exhibit 99.4 to the registrant's Registration Statement on Form S-8 (File No. 333-126834) as filed with the SEC on July 22, 2005</i>
10.23*	Iteris, Inc. Deferred Compensation Savings Plan and Grantor Trust	<i>Exhibit 10.31 to the registrant's Annual Report on Form 10-K for the year ended March 31, 2005 as filed with the SEC on July 14, 2005</i>
10.24+	Cooperative Agreement for Development, Manufacture, Marketing and Sale of Products to the Class 1 and Class 2 Vehicle Markets Incorporating Iteris LDWS Technology (Valeo Schalter and Sensoren GmbH)	<i>Exhibit 10.1 to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 as filed with the SEC on August 16, 2004</i>
10.25	Warrant Exercise Agreement dated September 27, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P.	<i>Exhibit 10.1 to the registrants' Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i>
10.26	Registration Rights Agreement dated September 28, 2006 by and among the registrant and Special Situations Fund III QP, L.P., Special Situations Fund III, L.P., Special Situations Cayman Fund, L.P. and Special Situations Private Equity Fund, L.P.	<i>Exhibit 10.2 to the registrants' Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i>

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- |        |  |  |
|--------|--|--|
| 10.27+ | National Intelligent Transportation Systems (ITS) Architecture Evolution and Support Award/Contract effective as of October 1, 2006 by and between the registrant and the Federal Highway Administration | <i>Exhibit 10.3 to the registrants' s Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |
| 10.28  | Loan and Security Agreement effective as of October 16, 2006 by and between the registrant and Silicon Valley Bank   | <i>Exhibit 10.4 to the registrants' s Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i> |

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Exhibit Number	Description	Where Located
10.29	Intellectual Property Security Agreement dated October 9, 2006 by and between the registrant and Silicon Valley Bank	<i>Exhibit 10.5 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as filed with the SEC on November 14, 2006.</i>
10.30+	Settlement Agreement, effective August 15, 2006, by and between the registrant and Delta Networks, Inc.	<i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on August 21, 2006</i>
10.31*	Offer letter effective February 28, 2007 by and between the registrant and Abbas Mohaddes	<i>Exhibit 10.1 to the registrant's Current Report on Form 8-K as filed with the SEC on March 6, 2007</i>
10.32*	Separation Agreement and Release of Claims dated March 1, 2007 by and between the registrant and Jack Johnson	<i>Exhibit 10.2 to the registrant's Current Report on Form 8-K as filed with the SEC on March 6, 2007</i>
21	Subsidiaries of the registrant	<i>Filed Herewith</i>
23	Consent of Independent Registered Public Accounting Firm	<i>Filed Herewith</i>
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed Herewith</i>
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	<i>Filed Herewith</i>
32.1	Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed Herewith</i>
32.2	Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	<i>Filed Herewith</i>

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\* Indicates a management contract or compensatory plan or arrangement

+ Confidential treatment has been requested for certain confidential portions of this exhibit pursuant to Rule 24b-2 of the Securities Exchange Act of 1934, as amended. In accordance with Rule 24b-2, these confidential portions have been omitted from the exhibit and filed separately with the SEC.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ITERIS, INC.**  
(Registrant)

By

*/s/* ABBAS MOHADDES  
Abbas Mohaddes  
President and Chief Executive Officer

**POWER OF ATTORNEY**

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We, the undersigned officers and directors of Iteris, Inc., do hereby constitute and appoint James S. Miele and Abbas Mohaddes, and each of them, our true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby, ratifying and confirming all that each of said attorneys-in-fact and agents, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated:

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ ABBAS MOHADDES Abbas Mohaddes	Director, President and Chief Executive Officer (principal executive officer)	June 21, 2007
/s/ JAMES S. MIELE James S. Miele	Chief Financial Officer (principal financial and accounting officer)	June 21, 2007
/s/ GREGORY A. MINER Gregory A. Miner	Chairman of the Board	June 21, 2007
/s/ RICHARD CHAR Richard Char	Director	June 21, 2007
/s/ KEVIN C. DALY Kevin C. Daly, Ph.D.	Director	June 21, 2007
/s/ GARY HERNANDEZ Gary Hernandez	Director	June 21, 2007
/s/ HARTMUT MARWITZ Hartmut Marwitz, Ph.D.	Director	June 21, 2007
/s/ JOHN SEAZHOLTZ John Seazholtz	Director	June 21, 2007
/s/ JOEL SLUTZKY Joel Slutzky	Director	June 21, 2007
/s/ THOMAS L. THOMAS Thomas L. Thomas	Director	June 21, 2007
/s/ PAUL E. WRIGHT Paul E. Wright	Director	June 21, 2007

**Iteris, Inc.**

**Index to Consolidated Financial Statements**

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of March 31, 2007 and 2006

Consolidated Statements of Operations for the years ended March 31, 2007, 2006, and 2005

Consolidated Statements of Stockholders' Equity and Comprehensive Income for the years ended March 31, 2007, 2006, and 2005

Consolidated Statements of Cash Flows for the years ended March 31, 2007, 2006, and 2005

Notes to Consolidated Financial Statements

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors  
Iteris, Inc.  
Anaheim, California

We have audited the consolidated balance sheets of Iteris, Inc. as of March 31, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity and comprehensive income and cash flows for each of the three years in the period ended March 31, 2007. Our audits also included the financial statement schedules of Iteris, Inc. listed in Item 15(a). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Iteris, Inc. as of March 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective April 1, 2006, the Company changed its method of accounting for stock-based compensation.

/s/ McGladrey & Pullen, LLP  
Irvine, California  
June 21, 2007



## Iteris, Inc.

## Consolidated Balance Sheets

(In thousands)

	March 31, 2007	2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 35	\$ 131
Trade accounts receivable, net of allowance for doubtful accounts of \$664 and \$429 at March 31, 2007 and 2006, respectively.	11,493	11,426
Costs and estimated earnings in excess of billings on uncompleted contracts	3,689	2,693
Deferred income taxes	494	790
Inventories, net of reserve for inventory obsolescence of \$844 and \$592 at March 31, 2007 and 2006, respectively	6,379	2,814
Prepaid expenses and other current assets	385	368
Total current assets	22,475	18,222
Property and equipment:		
Leasehold improvements	112	112
Equipment	6,830	6,638
Accumulated depreciation	(5,230 )	(4,967 )
	1,712	1,783
Deferred income taxes	2,533	818
Intangible assets, net of accumulated amortization of \$408 and \$261 at March 31, 2007 and 2006, respectively	404	551
Goodwill	27,774	27,774
Other assets	352	485
Total assets	\$ 55,250	\$ 49,633

See accompanying notes.

## Iteris, Inc.

## Consolidated Balance Sheets

(In thousands, except share and per share amounts)

	March 31, 2007	2006
Liabilities and stockholders' equity		
Current liabilities:		
Trade accounts payable	\$ 3,542	\$ 3,620
Accrued payroll and related expenses	3,527	3,481
Accrued liabilities	1,618	2,588
Revolving line of credit	4,015	2,662
Billings in excess of costs and estimated earnings on uncompleted contracts	847	893
Current portion of long-term debt	1,947	1,969
Total current liabilities	15,496	15,213
Non-current liabilities	163	177
Deferred compensation plan liability	730	820
Long-term debt	350	2,171
Convertible debentures, net	9,410	9,203
Commitments and contingencies		
Redeemable common stock		
Issued and outstanding shares 1,219,445 at March 31, 2007 and 2006	3,414	3,414
Stockholders' equity:		
Preferred stock:		
Authorized shares 2,000,000		
Issued and outstanding none		
Common stock, \$.10 par value:		
Authorized shares 50,000,000		
Issued and outstanding shares 30,600,717 at March 31, 2007 and 27,431,502 at March 31, 2006	3,060	2,743
Additional paid-in capital	130,425	126,664
Common stock held in trust 310,510 shares at March 31, 2007 and 2006	(374 )	(374 )
Notes receivable from employees	(5 )	(49 )
Accumulated deficit	(107,438 )	(110,356 )
Accumulated other comprehensive income	19	7
Total stockholders' equity	25,687	18,635
Total liabilities and stockholders' equity	\$ 55,250	\$ 49,633

See accompanying notes.

## Iteris, Inc.

## Consolidated Statements of Operations

(In thousands, except per share amounts)

	Year Ended March 31,		
	2007	2006	2005
Net sales and contract revenues:			
Net sales	\$ 36,248	\$ 31,156	\$ 29,062
Contract revenues	22,049	19,330	17,335
Total net sales and contract revenues	58,297	50,486	46,397
Costs of net sales and contract revenues:			
Cost of net sales (a)	19,829	16,493	15,925
Cost of contract revenues (a)	14,460	12,600	13,789
Gross profit	24,008	21,393	16,683
Operating expenses:			
Selling, general and administrative (a)	16,094	15,362	21,027
Research and development (a)	4,030	5,217	6,236
Amortization of intangible assets	147	147	114
Deferred compensation expense (benefit)	(91 )	48	(484 )
Disposal of fixed assets			422
Acquired in-process research and development			140
Total operating expenses	20,180	20,774	27,455
Operating income (loss)	3,828	619	(10,772 )
Non-operating income (expense):			
Other income (expense), net	(653 )	35	1,054
Interest expense, net	(1,600 )	(1,459 )	(1,178 )
Income (loss) before income taxes and minority interest	1,575	(805 )	(10,896 )
Income tax benefit	1,343	885	94
Minority interest in earnings of subsidiary			(526 )
Net income (loss)	\$ 2,918	\$ 80	\$ (11,328 )
Earnings (loss) per share:			
Basic	\$ 0.10	\$ 0.00	\$ (0.45 )
Diluted	\$ 0.09	\$ 0.00	\$ (0.45 )
Weighted average shares outstanding:			
Basic	29,698	28,182	25,284
Diluted	33,348	32,737	25,284

(a) Includes stock-based compensation expense as follows:

Cost of net sales	\$ 13	\$ 27	\$ 280
Cost of contract revenues	60	205	2,391
Selling, general and administrative expense	195	364	7,063
Research and development expense	20	129	2,043
Total stock-based compensation expense	\$ 288	\$ 725	\$ 11,777

See accompanying notes.



## Iteris, Inc.

## Consolidated Statements of Stockholders Equity and Comprehensive Income

(In thousands)

	Common Stock Shares Outstanding		Additional Paid-In Capital	Common Stock Held in Trust	Treasury Stock	Notes Receivable From Employees	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholder Equity (Deficit)	Comprehensive Income (Loss)
	Class A Shares	Class B Shares								
Balance at March 31, 2004	20,477	928	\$ 2,141	\$ 95,937	\$ (1 )	\$ (45 )	\$ (99,108 )	\$ (1,076 )		
Warrant exercises	402	40	344					384		
Stock option exercises	25	2	49					51		
Issuance of warrants in connection with convertible debentures				1,101				1,101		
Conversion of Class B common stock	1,020	(928 )	9	(9 )						
Convertible debenture conversion to common stock	69	7	205					212		
Issuance of common stock in connection with merger of Iteris Subsidiary	4,787	479	14,722					15,201		
Issuance of warrants Assumption of Iteris subsidiary stock options and warrants			26					26		
			12,383					12,383		
Common stock held in trust	310	31	343	(374 )						
Stock-based compensation			508					508		
Net loss							(11,328 )	(11,328 )	\$ (11,328 )	
Balance at March 31, 2005	27,090	2,709	125,609	(374 )	(1 )	(45 )	(110,436 )	17,462	\$ (11,328 )	
Warrant exercises	98	9	28					37		
Stock option exercises	244	25	275			(4 )		296		
Issuance of warrants			28					28		
Stock-based compensation			725					725		
Retirement of treasury stock			(1 )		1					
Foreign currency translation							7	7	\$ 7	
Net income							80	80	80	
Balance at March 31, 2006	27,432	2,743	126,664	(374 )	(49 )	(110,356 )	7	18,635	\$ 87	
Warrant exercises	1,706	170	2,265					2,435		
Stock option exercises	1,374	138	982					1,120		
Issuance of warrants			22					22		
Stock-based compensation			288					288		
Issuance of common stock in connection with legal settlement	89	9	204					213		
Repayment of notes receivable from employees						44		44		
Foreign currency translation							12	12	\$ 12	

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Net income						2,918		2,918	2,918
Balance at March 31, 2007	30,601	\$ 3,060	\$ 130,425	\$ (374 )	\$ (5 )	\$ (107,438 )	\$ 19	\$ 25,687	\$ 2,930

See accompanying notes.

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## Iteris, Inc.

## Consolidated Statements of Cash Flows

(In thousands)

	Year Ended March 31,		
	2007	2006	2005
<b>Operating activities</b>			
Net income (loss)	\$ 2,918	\$ 80	\$ (11,328 )
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Change in deferred tax assets	(1,419 )	(948 )	(200 )
Depreciation of property and equipment	559	684	787
Stock-based compensation	288	725	11,777
Amortization of deferred gain on sale-leaseback	(284 )	(284 )	(609 )
Issuance of common stock in connection with legal settlement	213		
Amortization of debt discounts	207	207	184
Amortization of intangible assets	147	147	114
Amortization of deferred financing costs	137	138	121
Fair value of warrants issued for services	22		26
Minority interest in earnings of subsidiary			526
Loss on disposal of assets			422
Write-off of acquired in-process research and development			140
Changes in operating assets and liabilities:			
Accounts receivable	(67 )	(2,560 )	(611 )
Net costs and estimated earnings in excess of billings	(1,042 )	(658 )	961
Inventories	(3,565 )	1,530	(746 )
Prepaid expenses and other assets	19	109	41
Accounts payable and accrued expenses	(182 )	1,048	(789 )
Deferred revenue			(226 )
Net cash provided by (used in) operating activities	(2,049 )	218	590
<b>Investing activities</b>			
Purchases of property and equipment	(488 )	(1,258 )	(670 )
Notes receivable			125
Acquisition costs			(80 )
Net cash used in investing activities	(488 )	(1,258 )	(625 )
<b>Financing activities</b>			
Proceeds from borrowings on lines of credit, net	1,353	1,717	845
Proceeds from long-term debt			5,000
Payments on long-term debt	(1,843 )	(1,314 )	(1,038 )
Credit facility commitment fees	(40 )		
Checks drawn in excess of available bank balances	(628 )	389	268
Proceeds from stock option and warrant exercises	3,555	333	501
Proceeds from notes receivable from employees	44		
Proceeds from issuance of convertible debentures			9,436
Purchase of Iteris subsidiary Series A preferred stock			(17,543 )
Net cash provided by (used in) financing activities	2,441	1,125	(2,531 )
Increase (decrease) in cash	(96 )	85	(2,566 )
Cash and cash equivalents at beginning of year	131	46	2,612
Cash and cash equivalents at end of year	\$ 35	\$ 131	\$ 46
<b>Supplemental cash flow information:</b>			
Cash paid (received) during the period:			
Interest	\$ 1,263	\$ 1,095	\$ 747
Income taxes	39	(2 )	624

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**Supplemental schedule of non-cash investing and financing activities:**

Property and equipment financing	\$	\$ 127	\$
Fair value of warrants issued in settlement of liabilities		28	
Exercises of stock options via notes receivable from employees		4	
Retirement of treasury stock		1	
Increase in promissory note to landlord to settle lease obligation			432
Acquisition of minority interest of the Iteris subsidiary			
Intangible assets			812
Deferred tax liabilities			360
Goodwill			17,887
Reduction of minority interest			1,253
Issuance of warrants in connection with Debenture and Warrant Purchase Agreement			1,101
Conversion of convertible debt to equity			250

See accompanying notes.

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**Iteris, Inc.**  
**Notes to Consolidated Financial Statements**  
**March 31, 2007**

**1. Description of Business and Summary of Significant Accounting Policies**

**Description of Business**

Iteris, Inc., formerly known as Iteris Holdings, Inc. (the Company), is a leading provider of outdoor machine vision systems and sensors that optimize the flow of traffic and enhance driver safety. Using proprietary software and Intelligent Transportation Systems (ITS) industry expertise, the Company provides video sensor systems, transportation management and traveler information systems and other engineering and consulting services to the ITS industry. The ITS industry is comprised of companies applying a variety of technologies to enable the safe and efficient movement of people and goods. The Company uses its outdoor image recognition software expertise to develop proprietary algorithms for video sensor systems that improve vehicle safety and the flow of traffic. Using its knowledge of the ITS industry, the Company designs and implements transportation management systems that help public agencies reduce traffic congestion and provide greater access to traveler information. On October 22, 2004, the Company completed the merger with its majority-owned subsidiary, Iteris, Inc. (the Iteris Subsidiary), and officially changed the Company's corporate name from Iteris Holdings, Inc. to Iteris, Inc. (Note 3). The Company was originally incorporated in Delaware in 1987 as Odetics, Inc. and in September 2003 changed its name to Iteris Holdings, Inc. to reflect its focus on the ITS industry and its capital structure at that time.

**Basis of Presentation**

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in the preparation of the consolidated financial statements include the allowance for doubtful accounts, deferred tax assets, inventory and warranty reserves, costs to complete long-term contracts, overhead rates used in cost-plus contracts, contract reserves, the valuation of equity instruments and estimates of future cash flows used to assess the recoverability of long-lived assets and the realization of goodwill.

**Reclassifications**

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

**Revenue Recognition**

Product revenues and related costs of sales are recognized upon the transfer of title, which generally occurs upon shipment or, if required, upon acceptance by the customer, provided that the Company believes collectibility of the net sales amount is reasonably assured. Accordingly, at the date revenue is recognized, the significant uncertainties concerning the sale have been resolved.

Contract revenues are derived primarily from long-term contracts with governmental agencies. Contract revenues include costs incurred plus a portion of estimated fees or profits determined on the percentage of completion method of accounting based on the relationship of costs incurred to total estimated costs. Any anticipated losses on contracts are charged to earnings when identified. Changes in job performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when their realization is reasonably assured.

In addition to product and contract revenue, the Company derives revenue from technology access fees, the provision of specific non-recurring contract engineering services and royalties. Technology access fee revenues are recognized evenly over the period in which they are earned. Non-recurring contract engineering revenues are recognized in the period in which the related services are performed. Royalty revenues are recorded in the period in which the royalty is earned, based on unit



sales of the Company's products. Technology access fee revenues, contract engineering revenues and royalty revenues are included in net sales in the accompanying consolidated statements of operations.

Revenues from follow-on service and support, for which the Company charges separately, are recorded in the period in which the services are performed.

### **Concentration of Credit Risk**

Accounts receivable are derived from revenues earned from customers located throughout North America and Europe. The Company generally does not require collateral or other security from customers. Collectibility of receivable balances is estimated through review of invoices outstanding greater than a certain period of time and ongoing credit evaluations of customers' financial condition. Reserves are maintained for potential credit losses, and such losses have historically been within management's expectations.

At March 31, 2007 and 2006, accounts receivable from governmental agencies and prime government contractors were approximately \$5.2 million and \$4.4 million, respectively. No customer or government agency had a receivable balance at March 31, 2007 or 2006 greater than 10% of our total net sales and contract revenues for the years ended March 31, 2007 and 2006.

### **Fair Values of Financial Instruments**

The fair value of cash and cash equivalents, receivables, inventories, accounts payable and accrued expenses approximate carrying value because of the short period of time to maturity. The fair value of line of credit agreements and long-term debt approximate carrying value because the related rates of interest approximate current market rates. The fair value of convertible debentures approximates carrying value because the effective interest rate, taking into account recorded debt discounts, approximates current market rates. At March 31, 2005, the fair value of redeemable common stock approximated carrying value since these shares were not tradable in any public equity markets. At March 31, 2007 and 2006, the estimated fair value of the redeemable shares was \$2.8 million and \$3.2 million, respectively, based on the closing price of the Company's common stock on that date.

### **Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and short-term investments with initial maturities of ninety days or less.

### **Inventories**

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

### **Property and Equipment**

Property and equipment are recorded at cost and are depreciated over the estimated useful life ranging from three to eight years. Leasehold improvements are depreciated over the term of the related lease or the estimated useful life of the improvement, whichever is shorter. Beginning April 1, 2006, the Company began depreciating property and equipment using the straight-line method of depreciation, which the Company believes more closely approximates the usage of the underlying assets, which generally provide value evenly throughout the estimated life. Prior to this date, the Company used the double declining balance method of depreciation. As a result of this change in estimate, depreciation expense declined by \$455,000 for the year ended March 31, 2007, resulting in a \$0.02 per share impact on basic and diluted earnings per share.

### **Goodwill and Long-Lived Assets**

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets* (SFAS 142), goodwill is tested for impairment on an annual basis in the Company's fourth fiscal quarter or more frequently if indicators of impairment exist, of which none have been identified. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company's reporting units with each respective reporting unit's carrying amount, including goodwill. The Company determines the fair value of reporting units using the income approach. If the carrying amount of a reporting unit exceeds the reporting unit's fair value, the second step of the goodwill impairment test is performed to determine the amount of any impairment loss. The second step of the goodwill



impairment test involves comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

The Company evaluates long-lived assets for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which requires impairment evaluation on long-lived assets used in operations when indicators of impairment are present. Reviews are performed to determine whether the carrying value of assets is impaired, based on a comparison to undiscounted expected future cash flows. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using discounted expected future cash flows and a discount rate based upon the Company's weighted average cost of capital adjusted for risks associated with the related operations. Impairment is based on the excess of the carrying amount over the fair value of those assets.

#### **Income Taxes**

The Company utilizes the liability method of accounting for income taxes as set forth in SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ). Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates. A valuation allowance is recorded when it is more likely than not that all or a portion of the deferred tax assets will not be realized. See Note 6.

#### **Stock-Based Compensation**

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Effective April 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ), which replaced SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), superceded Accounting Principles Board Opinion No. 25 ( APB 25 ), and amended SFAS No. 95, *Statement of Cash Flows*. Prior to April 1, 2006, the Company followed the disclosure-only provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, and, accordingly, accounted for its stock-based compensation plans using the intrinsic value method under APB 25 and related interpretations.

SFAS 123R requires all stock-based payments, including grants of employee stock options, to be recognized in the statement of operations as an expense, based on their grant date fair values with such fair values amortized over the requisite service period. The Company elected to use the modified prospective transition method for transition to SFAS 123R. Under the modified prospective method, SFAS 123R applies to all awards granted or modified after the date of adoption. In addition, under the modified prospective method, compensation expense will be recognized for all stock-based compensation awards granted prior to but not yet vested as of April 1, 2006, based on grant-date fair values estimated in accordance with the original provisions of SFAS 123. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS 123R.

The fair value concepts were not changed significantly as a result of implementing SFAS 123R; however, in adopting SFAS 123R, companies must choose among alternative valuation models and amortization assumptions. After assessing alternative valuation models and amortization assumptions, the Company continued to use both the Black-Scholes-Merton ( BSM ) option-pricing formula and straight-line amortization of compensation expense over the requisite service period of stock option grants. The Company will reconsider use of this model if additional information becomes available in the future that indicates another model would be more appropriate, or if grants issued in future periods have characteristics that cannot be reasonably estimated using this model. SFAS 123 did not require the estimation of forfeitures in the calculation of stock compensation expense; however, SFAS 123R does require such estimation and upon adoption of SFAS 123R, the Company changed its methodology to include an estimate of forfeitures.

In addition, in accordance with SFAS 123R, SFAS 109 and EITF Topic D-32, *Intraperiod Tax Allocation of the Tax Effect of Pretax Income from Continuing Operations*, the Company has elected to recognize excess income tax benefits from stock option exercises in additional paid-in capital only if an incremental income tax benefit would be realized after considering all other tax attributes presently available to the Company. The Company measures the tax benefit associated with excess tax deductions related to stock-based compensation expense by multiplying the excess tax deductions by the statutory tax rates.

As a result of implementing SFAS 123R, the Company recognized incremental stock-based compensation expense of \$208,000 for the year ended March 31, 2007, which reduced income before taxes and net income by \$208,000, and reduced basic and diluted earnings per share by \$0.01 for the year ended March 31, 2007. The adoption of SFAS 123R had no effect on cash flows from operating activities because no tax benefits are realized

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from stock option exercises. The adoption of SFAS 123R also had no effect on cash flows from financing activities because the Company did not realize any excess tax benefits from stock option exercises.

The following table illustrates the effect on net income (loss) and earnings (loss) per share for the years ended March 31, 2006 and 2005 as if the Company had applied the fair value recognition provisions of SFAS 123R to options granted under the Company's stock option plans. For purposes of this pro forma disclosure, the fair value of the options was estimated using the BSM option-pricing formula and amortized on a straight-line basis to expense over the options' vesting period:

	<b>Year Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>	
Net income (loss) as reported	\$ 80	\$ (11,328 )
Add: Stock-based compensation expense included in net income (loss) as reported	725	11,777
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	(1,108 )	(12,806 )
Net income (loss) pro forma	\$ (303 )	\$ (12,357 )
Basic and diluted earnings (loss) per share as reported	\$ 0.00	\$ (0.45 )
Basic and diluted loss per share pro forma	\$ (0.01 )	\$ (0.49 )

### **Research and Development Expenditures**

Research and development expenditures are charged to expense in the period incurred.

### **Shipping and Handling Costs**

Shipping and handling costs are included as cost of sales in the period during which the products ship.

### **Sales Taxes**

Sales taxes are presented on a net basis (excluded from net sales and contract revenues) in the consolidated statements of operations.

### **Advertising Expenses**

Advertising costs are expensed in the period incurred and totaled \$152,000, \$185,000 and \$112,000 in the years ended March 31, 2007, 2006 and 2005, respectively.

### **Warranty**

The Company generally provides a one to three year warranty from the original invoice date on all products, materials and workmanship. Products sold to certain original equipment manufacturer ( OEM ) customers sometimes carry longer warranties. Defective products will be either repaired or replaced, generally at the Company's option, upon meeting certain criteria. The Company accrues a provision for the estimated costs that may be incurred for product warranties relating to a product as a component of cost of sales at the time revenue for that product is recognized. The accrued warranty provision is included within accrued expenses on the accompanying consolidated balance sheets.

### **Repair and Maintenance Costs**

The Company incurs repair and maintenance costs in the normal course of business. Should the activity result in a permanent improvement to one of the Company's leased facilities, the cost is capitalized as a leasehold improvement and amortized over its useful life or the remainder of the lease period, whichever is shorter. Non-permanent repair and maintenance costs are charged to expense as incurred.

### **Comprehensive Income**

The only component of accumulated other comprehensive income is foreign currency translation adjustments.





## Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS 109. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48 and will adopt this Interpretation in the first quarter of its fiscal year ending March 31, 2008.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. SFAS 157 does not require any new fair value measurements; rather it specifies valuation methods to be applied when fair value measurements are required under existing or future accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application of the statement is encouraged. Generally, this statement will be applied prospectively. The Company is currently evaluating the impact of SFAS 157 and expects to adopt SFAS 157 in the first quarter of its fiscal year ending March 31, 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is evaluating the impact that the adoption of SFAS 159 will have on its results of operations and financial condition and expects to adopt SFAS 159 in its fiscal year ending March 31, 2009.

## 2. Supplementary Financial Information

### Inventories

The following table presents details regarding the Company's inventories:

	March 31, 2007 (In thousands)	2006
Materials and supplies	\$ 4,705	\$ 2,258
Work in process	366	217
Finished goods	1,308	339
	\$ 6,379	\$ 2,814

### Goodwill and Intangible Assets

	March 31, 2007 Gross Carrying Amount (In thousands)	Accumulated Amortization	March 31, 2006 Gross Carrying Amount	Accumulated Amortization
Intangible assets subject to amortization:				
Developed Technology	\$ 495	\$ (280 )	\$ 495	\$ (179 )
Patents	317	(128 )	317	(82 )
Total	\$ 812	\$ (408 )	\$ 812	\$ (261 )

Amortization expense for intangible assets subject to amortization was \$147,000 for the years ended March 31, 2007 and 2006 and \$114,000 for the year ended March 31, 2005. Future estimated amortization expense for the next five years is as follows:

### Year Ending March 31:

(In thousands)

2008	\$ 147
2009	147
2010	58

## Stock-Based Compensation

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2011	46
2012	6
	\$ 404

At March 31, 2007, goodwill was comprised of \$18.0 million associated with the October 2004 merger of the Iteris Subsidiary (Note 3); \$9.6 million associated with the acquisitions of the Rockwell International Transportation Systems Group, Meyer Mohaddes Associates and the Viggen Systems Consulting Group; and \$200,000 associated with the purchase of the assets of Mil-Lektron, a complementary product to the Company's Vantage video detection business.

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**Warranty Reserve Activity**

The following table presents activity in accrued warranty obligations:

	<b>Year Ended March 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>		
Balance at beginning of year	\$ 519	\$ 326	\$ 192
Additions charged to cost of sales	630	517	614
Warranty claims	(629 )	(324 )	(480 )
Balance at end of year	\$ 520	\$ 519	\$ 326

**Earnings (Loss) Per Share**

The following table sets forth the computation of basic and diluted income (loss) per share:

	<b>Year Ended March 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>		
<b>Numerator:</b>			
Net income (loss)	\$ 2,918	\$ 80	\$ (11,328 )
<b>Denominator:</b>			
Weighted average common shares used in basic computation	29,698	28,182	25,284
Dilutive stock options	3,346	3,818	
Dilutive warrants	304	737	
Weighted average common shares used in dilutive computation	33,348	32,737	25,284
<b>Earnings (loss) per share:</b>			
Basic	\$ 0.10	\$ 0.00	\$ (0.45 )
Diluted	\$ 0.09	\$ 0.00	\$ (0.45 )

The following shares were excluded from the computation of diluted earnings (loss) per share as their effect would have been anti-dilutive:

	<b>Year Ended March 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>		
Stock options	582	470	4,560
Warrants	1,240	1,265	1,095
Convertible debentures	2,729	2,729	2,729

### 3. Merger of the Company and the Iteris Subsidiary

On May 28, 2004 (the Closing Date), in order to simplify the Company's capital structure and facilitate the merger of the Iteris Subsidiary into the Company, the Company completed the purchase of all of the outstanding shares of the Series A preferred stock of the Iteris Subsidiary (the Series A preferred stock), which were held by DaimlerChrysler Ventures GmbH (DCV) and Hockenheim Investment Pte. Ltd. (Hockenheim), in exchange for approximately \$17.5 million in cash. In addition, the Company acquired all of the 547,893 shares of common stock of the Iteris Subsidiary held by DCV in exchange for the issuance of 1,219,445 shares of the Company's Class A common stock (now known as the Company's common stock) which was valued at \$3.4 million at the date of issuance. The fair value of the Company's common stock issued in the transaction was based on the quoted market price of the Company's stock on the OTC Bulletin Board averaged over a five-day period. The purchase and exchange of the shares were made pursuant to a Stock Purchase and Exchange Agreement dated March 31, 2004, by and among the Company, the Iteris Subsidiary, DCV and Hockenheim (the Purchase and Exchange Agreement).

Pursuant to the Purchase and Exchange Agreement, the Company purchased 3,124,913 shares of the Series A preferred stock of the Iteris Subsidiary from DCV and Hockenheim for a purchase price of \$5.61 per share. The purchase price represented the stated redemption value of the Series A preferred stock. The purchase of the shares was financed primarily with a \$10.1 million convertible debenture financing completed in May 2004 with a group of accredited investors, in addition to a \$5.0 million senior credit facility arranged through a bank and \$2.4 million in cash (Note 5).

On June 30, 2004, the Company and certain minority stockholders of the Iteris Subsidiary (including certain officers and directors) entered into an exchange agreement whereby an aggregate of 1,319,541 shares of common stock of the Iteris Subsidiary were exchanged for 2,639,082 shares of the Company's newly issued common stock valued at \$8.6 million at the date of issuance. The fair value of the Company's stock issued in the transaction was based on the quoted market price of the Company's common stock on the OTC Bulletin Board averaged over a five-day period. The effect of this exchange was to reduce the residual minority interest in the Iteris Subsidiary to 8.1%.

On October 22, 2004, the Iteris Subsidiary was merged into the Company. The remaining 8.1% minority interest in the Iteris Subsidiary (consisting of 1,228,981 shares of common stock of the Iteris Subsidiary) was converted to 2,457,962 shares of the Company's common stock valued at \$7.6 million at the merger date. Immediately following the merger, the Company converted all of its outstanding Class B common stock (921,917 shares) into 1,014,108 shares of its common stock (formerly designated as Class A common stock). The exchange ratio used in conversion was determined by the Company's Board of Directors. The fair value of the Company's common stock issued in the transaction was based on the quoted market price of the Company's common stock on the OTC Bulletin Board averaged over a five-day period. In October 2004, the Company also amended its certificate of incorporation to (a) change the voting rights of its common stock from one-tenth to one vote per share, (b) remove the ability to issue any further shares of Class B common stock, and (c) rename its Class A common stock to common stock. As a result, the Company currently has only one class of common stock outstanding, the common stock.

In connection with the merger, the Company assumed all outstanding options and warrants to purchase shares of common stock of the Iteris Subsidiary that were outstanding immediately prior to the merger, whether vested or unvested, together with the Iteris Subsidiary's 1998 Stock Incentive Plan. Each such option and warrant assumed by the Company shall continue to have, and be subject to, the same terms and conditions as were applicable immediately prior to the merger, provided that (A) such option or warrant shall be exercisable for that number of whole shares of the Company's common stock equal to the product of the number of shares of the Company's common stock that were issuable upon exercise of such assumed option or warrant immediately prior to the merger multiplied by two (2) (the Exchange Ratio) rounded down to the nearest whole number of shares and (B) the per share exercise price for the shares of the Company's common stock issuable upon exercise of such assumed option or warrant is equal to the quotient determined by dividing the exercise price per share at which such option or warrant was exercisable immediately prior to the merger by the Exchange Ratio (rounded up to the nearest whole cent). As a result, options and warrants to purchase approximately 3.1 million shares and 327,000 shares, respectively, of common stock of the Iteris Subsidiary assumed in the merger became options and warrants to purchase approximately 6.1 million and 654,000 shares, respectively, of common stock of the Company. The weighted-average exercise prices of the assumed options and warrants were \$1.09 and \$2.32, respectively. Stock-based compensation expense of \$11.3 million was recorded in connection with the assumption and exchange of vested Iteris Subsidiary stock options for stock options immediately exercisable into the Company's common stock based on the difference between the fair market value of the Company's common stock on the October 22, 2004 merger date and the exercise price of the modified stock option. Additionally, the Company recorded approximately \$1.4 million in deferred compensation related to the assumption of

unvested stock options to purchase common stock of the Iteris Subsidiary. Deferred compensation was amortized to stock-based compensation expense as the options vested; and all such options were fully vested at March 31, 2007. The Company also recorded \$1.1 million of goodwill and additional paid-in-capital in connection with the 654,000 vested warrants assumed in the merger and acquisition of the Iteris Subsidiary. The \$1.1 million value was based on the difference between the fair market value of the Company's common stock on the October 22, 2004 merger date and modified exercise price of the assumed warrant awards.

The excess of the purchase price over the proportionate amount of minority interest acquired was allocated to acquired intangible assets based on the estimated fair values with the residual allocated to goodwill. Accordingly, the Company recorded goodwill of \$18.0 million, which represents the excess of the purchase price over the fair value of the proportionate identifiable net assets acquired. The estimated fair value of the intangible assets was determined using the income method and discounting future expected returns. The estimated useful life for each of the acquired intangible assets is provided below:

Patents	7 years
Developed technology	5 years

The following table summarizes fair values of the assets acquired and liabilities assumed and the allocation of the purchase price at the date of acquisition (in thousands):

<b>Acquisition costs:</b>	
Issuance of common stock	\$ 18,617
Assumption of Iteris Subsidiary warrants	1,114
Purchase of Iteris Subsidiary Series A preferred stock	17,543
Acquisition costs	80
Total acquisition costs	\$ 37,354
<b>Purchase price allocation:</b>	
Fair value of 41% of Iteris Subsidiary	
Patents	\$ 317
Developed technology	495
Acquired in-process research and development	140
Deferred tax liabilities	(360 )
Reduction of minority interest	18,794
Goodwill (not deductible for tax purposes)	17,968
Total purchase price allocation	\$ 37,354

On October 22, 2004, in connection with the Company's merger with the Iteris Subsidiary, the Chief Executive Officer of the Iteris Subsidiary was promoted to President and Chief Executive Officer of the Company, replacing Mr. Gregory Miner. This merger triggered certain obligations under the Company's change-in-control agreement with Mr. Miner. Accordingly, the Company recorded approximately \$807,000 in severance expense, which included \$57,000 for related payroll taxes, as a charge to operations for the year ended March 31, 2005. The severance amount was paid to Mr. Miner in bi-weekly installments over 30 months, and the final payment was made in April 2007.

#### 4. Costs and Estimated Earnings on Uncompleted Contracts

Costs incurred, estimated earnings and billings on uncompleted long-term contracts are as follows:

	March 31, 2007 (In thousands)	2006
Total estimated contract value	\$ 74,794	\$ 74,990
Costs incurred on uncompleted contracts	\$ 20,688	\$ 18,233
Estimated earnings	2,069	1,823
	22,757	20,056
Less billings to date	(19,915 )	(18,256 )
	\$ 2,842	\$ 1,800
Included in accompanying consolidated balance sheets:		
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 3,689	\$ 2,693
Billings in excess of costs and estimated earnings on uncompleted contracts	(847 )	(893 )
	\$ 2,842	\$ 1,800

Costs and estimated earnings in excess of billings at March 31, 2007 and 2006 include \$786,000 and \$806,000, respectively, that were not billable as certain milestone objectives specified in the contracts had not been attained. Substantially all costs and estimated earnings in excess of billings at March 31, 2007 are expected to be billed and collected during the year ending March 31, 2008.

#### 5. Revolving Line of Credit and Long-Term Debt

##### Revolving Line of Credit

On May 28, 2004, the Iteris Subsidiary entered into a line of credit agreement with its former bank, which provided for a maximum available credit line of \$5.0 million. This line of credit was assumed by the Company in October 2004 and expired on October 31, 2006.

In October 2006, the Company replaced its former credit facility and entered into a new two-year credit facility with a different bank. The new facility provides for combined line of credit and term note borrowings of up to \$8.0 million. Under the new credit facility, the Company may borrow against its eligible accounts receivable and eligible inventory, as defined in the credit agreement. Line of credit interest on borrowed amounts is payable monthly at the current stated prime rate plus 1.25%. Additionally, the Company is obligated to pay an unused line fee of 0.25% per annum applied to the amount by which the maximum credit amount exceeds the average daily principal balance during the preceding month. The new credit facility requires \$2,000 in monthly collateral management fees and includes an early termination fee equal to 2% of the total facility during the first year of the agreement and 1% of the total facility in the second year of the agreement. Additionally, the Company paid a commitment fee of \$40,000 in October 2006 and is obligated to pay an additional \$40,000 on the one-year anniversary of the facility. The new credit facility is secured by substantially all of the assets of the Company.

On March 31, 2007, the available credit under the credit facility was \$8.0 million, of which \$2.4 million was unused.

**Long-Term Debt**

Long-term debt consists of the following:

	March 31, 2007	2006
	(In thousands)	
Convertible debentures, net	\$ 9,410	\$ 9,203
Bank term note	1,573	2,708
Promissory note to landlord	646	1,292
Other	78	140
	11,707	13,343
Less current portion	(1,947 )	(1,969 )
	\$ 9,760	\$ 11,374

*Convertible Debentures, Net.* In order to finance the purchase of the Iteris Subsidiary Series A preferred stock (Note 3), the Company entered into a Debenture and Warrant Purchase Agreement dated May 19, 2004 (the Debenture and Warrant Purchase Agreement), with a group of accredited investors, which included certain officers of the Company, pursuant to which the Company sold and issued subordinated convertible debentures in the aggregate original principal amount of \$10.1 million. In connection with the issuance of the convertible debentures, the Company issued detachable warrants to purchase an aggregate of 639,847 shares of its common stock (Note 9), the value of which was recorded as a debt discount against the face amount of the debentures on the date of issuance and is being amortized to interest expense over the term of the convertible debentures.

The debentures are due in full on May 19, 2009, provide for 6.0% annual interest, payable quarterly, and are convertible at the holder's option into the Company's common stock at an initial conversion price of \$3.61 per share, subject to certain adjustments, including adjustments for dilutive issuances. From May 19, 2007, until May 18, 2008, the debentures may be redeemed by the Company, at its option, at 120% of the principal amount being redeemed; and from May 19, 2008, until the maturity date, the debentures may be redeemed at 110% of the principal amount being redeemed. During the year ended March 31, 2005, \$250,000 of convertible debentures were converted into 69,252 shares of common stock leaving \$9.9 million of the originally issued convertible debentures outstanding at March 31, 2007 and 2006.

*Bank Term Note.* Concurrent with the Company's issuance of the convertible debentures, the Iteris Subsidiary entered into a \$5.0 million term note with a bank. This note was assumed by the Company in October 2004. The proceeds from the note were used to purchase the Series A preferred stock of the Iteris Subsidiary (Note 3). The note was due on May 27, 2008, and provided for monthly principal payments of approximately \$104,000. Interest accrued at the current stated prime rate plus 0.25%. In October 2006, the term note was transferred to the Company's new bank as part of the Company's new \$8.0 million credit facility. The new term note is also due on May 27, 2008 and provides for monthly principal payments of approximately \$104,000. Interest accrues under the new term note at the current stated prime rate plus 1.25%. Amounts due under the term note reduce the Company's ability to borrow against its eligible assets on its line of credit.

Both the new bank term note and the new line of credit are held by one bank under the same credit agreement and are secured by substantially all of the assets of the Company.

*Promissory Note to Landlord.* The Company has a \$1.3 million unsecured promissory note payable to the landlord of its Anaheim headquarters. Under the terms of the note agreement, interest is payable quarterly and accrues at a rate of prime plus 2.0% (10.25% at March 31, 2007). In October 2006, January 2007 and April 2007, the Company made the first three of four required equal quarterly principal payments of \$323,000. All outstanding accrued interest and principal are payable in full on July 1, 2007.





Scheduled aggregate maturities of long-term debt principal as of March 31, 2007 were as follows:

Year Ending March 31,  
(In thousands)

2008	\$ 1,947
2009	350
2010	9,850
	12,147
Less: unamortized debt discount	(440 )
	\$ 11,707

## 6. Income Taxes

The reconciliation of the Company's income tax benefit to taxes computed at U.S. federal statutory rates is as follows:

	Year Ended March 31,		2005
	2007	2006	
	(In thousands)		
Income tax (benefit) provision at statutory rates	\$ 536	\$ (284 )	\$ (3,705 )
State income taxes net of federal benefit	(147 )	(85 )	(72 )
Change in valuation allowance associated with federal deferred tax assets	(1,895 )	(892 )	(755 )
Compensation charges		222	3,692
Adjustment to prior year deferred taxes			229
Expiration of unused credits			266
AMT and foreign taxes	24	46	
Other permanent differences	139	108	251
Income tax benefit	\$ (1,343 )	\$ (885 )	\$ (94 )

The components of deferred tax assets and liabilities are as follows:

	March 31,	2006
	2007	
	(In thousands)	
Deferred tax assets:		
Net operating losses	\$ 18,806	\$ 18,061
Property and equipment		623
Credit carry forwards	1,401	1,356
Deferred compensation and payroll	2,032	1,770
Bad debt allowances and other reserves	524	410
Acquired intangibles	67	
Other, net		124
Total deferred tax assets	22,830	22,344
Valuation allowance	(19,543 )	(20,516 )
Net deferred tax assets	3,287	1,828
Deferred tax liabilities:		
Other, Net	(135 )	
Property and equipment	(125 )	
Acquired intangibles		(220 )
Total deferred tax liabilities	(260 )	(220 )
Net deferred tax assets	\$ 3,027	\$ 1,608
Current portion of net deferred taxes		
Long-term portion of net deferred taxes	494	790
Net deferred tax assets	2,533	818
Net deferred tax assets	\$ 3,027	\$ 1,608



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The components of current and deferred federal and state income tax benefits and provisions are as follows:

	Year Ended March 31,		
	2007	2006	2005
	(In thousands)		
<b>Current income tax provision</b>			
Federal	\$ 25	\$ 9	\$ 91
State	32	3	14
Foreign	24	46	
<b>Deferred income tax benefit</b>			
Federal	(1,170 )	(812 )	(75 )
State	(254 )	(131 )	(124 )
Net income tax benefit	\$ (1,343 )	\$ (885 )	\$ (94 )

At March 31, 2007, the Company had approximately \$583,000 in federal general business credit carryforwards that begin to expire in 2008 and \$818,000 in state general business credit carryforwards that can be carried forward indefinitely. The Company had \$49.3 million of federal net operating loss carryforwards at March 31, 2007, that begin to expire in 2019 and \$22.4 million of state net operating loss carryforwards that begin to expire in 2008.

Prior to May 28, 2004, the Iteris Subsidiary was required to file a separate federal income tax return. On May 28, 2004, the Company acquired a greater than 80% ownership interest in the Iteris Subsidiary. From that date forward, income taxes are provided on a consolidated basis for federal income tax purposes. Due to changes in stock ownership, the prior year \$49.8 million of federal net operating loss carryforwards and other federal tax attributes of the Company are subject to a Section 382 limitation estimated at approximately \$2.9 million annually which can be utilized to offset federal consolidated taxable income. To the extent such limitation is not exceeded in a particular year, the excess limitation accumulates and adds to subsequent years' limitations.

At March 31, 2007, the Company recorded a valuation allowance against its net deferred tax assets of approximately \$19 million for that portion of deferred tax assets that it is more likely than not will not be realized. In making such determination, a review of all available positive and negative evidence was considered, including scheduled reversal of deferred tax liabilities, potential carryback, projected future taxable income, tax planning strategies, and recent financial performance. Any future benefits recognized from the reduction of the valuation allowance will result in a reduction of income tax expense.

Unremitted earnings of the Company's foreign subsidiary have been included in the consolidated financial statements without giving effect to the United States taxes that may be payable on distribution to the United States because it is not anticipated that such earnings will be remitted to the United States. If remitted, the additional United States taxes would not be material.

## 7. Commitments and Contingencies

### Litigation

On June 29, 2004, a supplier to Mariner Networks, Inc., a former subsidiary of the Company that was discontinued in the fiscal year ended March 31, 2002, filed a complaint in Orange County Superior Court against the Company alleging various breaches of written contract claims arising out of alleged purchase orders. The plaintiff in this lawsuit sought monetary damages aggregating approximately \$850,000 plus attorney fees and related costs. On July 20, 2006, the Company entered into a settlement agreement in connection with this matter. The dispute was settled in full for \$688,000 payable as follows: (i) the Company issued 88,912 shares of the Company's common stock on August 18, 2006 valued at \$213,000 based on the closing sales price of the Company's common stock on the date of issuance; (ii) the Company made a cash payment of \$125,000 on October 20, 2006; and (iii) the Company is obligated to pay \$350,000 in cash in equal monthly installments of \$9,700 over three years beginning in November 2006. In connection with this settlement, the Company recorded a charge of \$635,000, representing the fair value of the settlement, within other expense in the accompanying consolidated statement of operations for the year ended March 31, 2007.

In June 2004, the Company received \$949,000 as part of a settlement between Rockwell International and the Michigan Department of Transportation, pursuant to which the Company was a third party beneficiary. This amount was recorded in other income in the consolidated statement of operations for the year ended March 31, 2005.



From time to time, the Company has been involved in litigation relating to claims arising out of its operations in the normal course of business. The Company currently is not a party to any legal proceedings, the adverse outcome of which, in management's opinion, individually or in the aggregate, would have a material adverse effect on its consolidated results of operations, financial position or cash flows.

Furthermore, from time to time, the Company has experienced unforeseen developments in contingencies related to its former subsidiaries. For example, the Company has been the subject of a number of routine tax audits for time periods and jurisdictions related to the businesses of its former subsidiaries, some of which are still in process. Although the development and ultimate outcome of these and other unforeseen matters cannot be predicted with any certainty, management does not believe that the Company is presently involved in any matters related to its former subsidiaries that would have a material adverse effect on the Company's consolidated results of operations, financial position or cash flows.

### Operating Leases

The Company has lease commitments for facilities in various locations throughout the United States. Future minimum rental payments under these noncancelable operating leases at March 31, 2007 were as follows:

**Fiscal Year Ending March 31,  
(In thousands)**

2008	\$ 1,277
2009	1,398
2010	1,391
2011	1,348
2012	1,332
Thereafter	3,823
<b>Total</b>	<b>\$ 10,569</b>

Rent expense totaled \$2.2 million, \$1.9 million and \$1.7 million, respectively, for the years ended March 31, 2007, 2006 and 2005.

The Company has recorded on its consolidated balance sheet a deferred gain related to the May 2002 sale and leaseback of its headquarters in Anaheim, California. The deferred gain is being amortized over the term of the underlying lease, which terminates in September 2007, and resulted in a realized gain of \$284,000 in the fiscal years ended March 31, 2007 and 2006, and \$609,000 in the fiscal year ended March 31, 2005. The remaining deferred gain was \$165,000 at March 31, 2007.

The Company subleases 10,000 square feet of space in its 94,000 square foot Anaheim, California facility at a monthly rate of \$10,000 to MAXxess Systems, Inc. (MAXxess), a former subsidiary of the Company that was sold in September 2003 and is currently owned by an investor group that includes one of the Company's directors. During the fiscal year ended March 31, 2007, the Company wrote off amounts receivable from MAXxess aggregating \$180,000 related primarily to this sublease due to MAXxess' inability to pay this balance. As a result of this write-off, the Company does not expect to recognize any future sublease income related to this sublease, which terminates in September 2007.

On May 25, 2007, the Company entered into an agreement to lease approximately 50,000 square feet of space in Santa Ana, California for a term of 88 months, beginning in September 2007. This location will be the new location of the Company's headquarters and principal operations. The monthly lease rate will be \$102,000 during the first year of the lease, and will increase each year thereafter, up to a maximum of \$120,000 during the last year of the lease. The lease may be extended for a period of five years, at the option of the Company, at a lease rate to be based on the market lease rate for comparable property determined as of the commencement date of the extension period. Future lease commitments under this lease are included in the above table of lease commitments.

### Inventory Purchase Commitments

At March 31, 2007, the Company had firm commitments to purchase inventory in the amount of \$2.6 million during the first and second quarters of its fiscal year ending March 31, 2008.

### **Deferred Compensation Plan**

In 1986, the Company adopted the Executive Deferral Plan (the 1986 Plan ) under which certain executives were able to defer a portion of their annual compensation into the 1986 Plan. All deferred amounts earned interest, generally with no guaranteed rate of return.

During the year ended March 31, 2003, the Iteris Subsidiary adopted the Deferred Compensation Plan for the sole purpose of transferring Iteris Subsidiary common stock and cash out of the 1986 Plan. All assets of the 1986 Plan were distributed prior to March 31, 2003. Certain of these assets, consisting of 133,333 shares of the Iteris Subsidiary s common stock and \$14,000 in cash, were transferred to the Deferred Compensation Plan during the year ended March 31, 2003. No compensation withholdings were deferred under the 1986 Plan or the Deferred Compensation Plan in the years ended March 31, 2007, 2006 and 2005.

During the year ended March 31, 2005, the Company assumed the Deferred Compensation Plan as part of the October 2004 merger and acquisition of the Iteris Subsidiary. In accordance with the merger (Note 3) the Company exchanged the original 133,333 shares of Iteris Subsidiary common stock held in the Deferred Compensation Plan and an additional 21,922 shares of the Iteris Subsidiary s common stock subsequently purchased with deferred wages for 310,510 shares of the Company s common stock. All shares of Iteris Subsidiary stock held in the plan were purchased with funds earned by the executives and deferred to the plan at the estimated fair value and the same price that was paid by outside investors at that time, or approximately \$374,000.

At March 31, 2007, the Deferred Compensation Plan held 310,510 shares of the Company s common stock and \$15,000 in cash, which the Company has presented as an aggregated \$730,000 deferred compensation plan liability in the accompanying consolidated balance sheet. Changes in the value of Company common stock held by the Deferred Compensation Plan are determined based on changes in the quoted market price of the Company s common stock at the close of each reporting period and presented within operating expenses in the accompanying consolidated statements of operations. The original \$374,000 cost basis of shares of Company common stock held in the Deferred Compensation Plan has been recorded as a contra-equity account in the accompanying consolidated financial statements. In May 2007, the Company s former Chief Executive Officer, who departed in March 2007, elected to receive a distribution of fifty percent of his deferred compensation plan balance, representing 143,333 shares of the Company s common stock and \$8,000 in cash, on or before June 30, 2007, and his remaining deferred compensation plan balance of 143,333 shares of the Company s common stock and \$7,000 in cash on the one year anniversary of this election.

### **8. Redeemable Common Stock**

As discussed in Note 3, the Company issued 1,219,445 shares of its Class A common stock (now known as common stock) ( Exchange Shares ) in connection with the merger of the Iteris Subsidiary into the Company. Beginning on November 28, 2005, DCV may require the Company to repurchase up to 50% of the Exchange Shares at a purchase price of \$1.438 per share; and beginning on May 28, 2007, DCV may require the Company to repurchase up to 100% of the Exchange Shares at a purchase price of \$1.438 per share. All such rights to require the repurchase of the Exchange Shares expire on September 28, 2007. Because this right is outside the control of the Company, the Company has classified the \$3.4 million value of the 1,219,445 shares as redeemable common stock on the accompanying March 31, 2007 and 2006 consolidated balance sheets. On February 1, 2005, DCV announced that its investment portfolio, which included its ownership in Iteris, Inc., was sold to European-based Cipio Partners for an undisclosed sum. All repurchase rights associated with the DCV shares inured to the benefit of Cipio Partners.

### **9. Stockholders Equity**

#### **Preferred Stock**

The Company s certificate of incorporation provides for the issuance of up to 2,000,000 shares of preferred stock. As of March 31, 2007 and 2006, there were no outstanding shares of preferred stock, and the Company does not have any plans to issue any shares of preferred stock. The Company s Board of Directors is authorized to issue from time to time such authorized but unissued shares of preferred stock in one or more series and to fix or alter the designations, preferences, rights and any qualifications, limitations or restrictions of the shares of each such series, including the dividend, conversion, voting, redemption and liquidation rights.

### Common Stock and Common Stock Warrants

On September 28, 2006, the Company issued warrants to purchase an aggregate 246,250 shares of common stock at an exercise price of \$3.25 with a five-year life to an existing shareholder in exchange for the early exercise of 1,250,000 outstanding warrants with an exercise price of \$1.61. The new warrants were immediately exercisable and are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price greater than or equal to two times the exercise price of the warrants. The fair value of the new warrants was \$320,000 calculated using the Black-Scholes-Merton (BSM) option-pricing formula. The warrants were considered a cost of raising capital and were recorded in equity.

In connection with the issuance of the new warrants, the Company is party to a registration rights agreement that contains provisions under which the Company could be subjected to liquidated damages should it fail to maintain effective registration statements for the shares of common stock issuable upon exercise of the warrants. These warrants have been accounted for within equity in the consolidated balance sheet as of March 31, 2007 in accordance with EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and, accordingly, no liabilities have been recorded in connection therewith. As of March 31, 2007, no liquidated damages were payable under the provisions of the registration rights agreement associated with these warrants.

As discussed in Note 3, on October 22, 2004, the Iteris Subsidiary was merged into the Company. Also in October 2004, the Company amended its certificate of incorporation to (a) change the voting rights of its Class A common stock from one-tenth to one vote per share, (b) remove the ability to issue any further shares of Class B common stock, and (c) rename its Class A common stock to common stock. As a result, the Company currently has only one class of common stock outstanding, the common stock. Previously, the Company had two classes of common stock outstanding—the Class A common stock and the Class B common stock.

Subject to the rights specifically granted to holders of any then outstanding shares of the Company's preferred stock, the Company's common stockholders are entitled to any dividends that may be declared by the Board of Directors. Upon dissolution, liquidation or winding up, holders of common stock are entitled to share ratably in net assets after payment or provision for all liabilities and any preferential liquidation rights of preferred stock then outstanding. Common stockholders generally do not have preemptive or redemption rights, except for the Exchange Shares issued to DCV in exchange for shares of the Iteris Subsidiary (Notes 3 and 8). The rights, preferences and privileges of holders of common stock will be subject to those of the holders of any shares of common stock and preferred stock the Company may issue in the future.

Pursuant to the Debenture and Warrant Purchase Agreement discussed in Note 5, each individual investor also received two warrants to purchase shares of the Company's common stock. For every dollar of debenture purchased, each investor received one warrant to purchase approximately 0.03235 shares of the Company's common stock at an exercise price of \$3.86 per share and a second warrant to purchase approximately 0.03100 shares of the Company's common stock at an exercise price of \$4.03 per share. The exercise prices are subject to certain adjustments, including adjustments for dilutive issuances. The warrants to purchase 639,847 shares of common stock were immediately exercisable and expire on May 18, 2009. Debt discount costs related to the fair value of the warrants issued in connection with the convertible debentures were calculated based on the fair value of the warrants determined using the Black-Scholes valuation model and are being amortized to interest expense over the five-year term of the debentures. Significant valuation estimates used in the determination of the value of the warrants include an expected life of five years, no dividends, a risk-free interest rate of 4.5% and a stock volatility factor of 0.5. Unamortized debt discount aggregated \$440,000 and \$647,000 at March 31, 2007 and 2006, respectively, and is classified within convertible debentures, net on the accompanying consolidated balance sheets.

Also in connection with the Debenture and Warrant Purchase Agreement, the Company issued warrants to the investment bankers, as a commission, to purchase 34,036 shares of its common stock at an exercise price of \$3.86 per share. The warrants were immediately exercisable and expire on May 18, 2009. The estimated fair value of these warrants of \$40,000 was recorded as a deferred financing cost and is being amortized to interest expense over the five-year life of the debentures. Additionally, the Company incurred \$621,000 in transaction costs associated with the debenture offering, which have also been capitalized as deferred financing costs and are being amortized to interest expense over the five-year term of the debentures. Unamortized deferred financing costs aggregated \$293,000 and \$430,000 at March 31, 2007 and 2006, respectively, and are classified within other assets on the accompanying consolidated balance sheets.

The following table summarizes information regarding outstanding warrants to purchase the Company's common stock as of March 31, 2007:

Range of Exercise Prices	Warrants Outstanding at March 31, 2007 (In thousands, except per share amounts)	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price
\$1.42 to \$1.95	127	1.12	\$ 1.78
\$2.45 to \$3.25	286	3.70	\$ 3.14
\$3.61 to \$4.03	674	2.13	\$ 3.93
\$5.00 to \$5.26	230	2.66	\$ 5.18
	1,317	2.47	\$ 3.77

All of the warrants were exercisable at March 31, 2007. Warrants to purchase an aggregate of 62,500 shares of common stock at an exercise price of \$1.95 per share and warrants to purchase an aggregate of 246,260 shares of common stock at an exercise price of \$3.25 per share are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price equal to or greater than two times the exercise price of the warrants. Warrants to purchase an aggregate of 75,000 shares of common stock at an exercise price of \$5.00 per share are callable by the Company if the market price of the Company's common stock trades for 20 consecutive days at a price equal to or greater than one and a half times the exercise price of the warrants.

Common stock reserved for future issuance at March 31, 2007:

	(In thousands)
Issuable under stock options plans	5,827
Issuable upon the exercise of warrants	1,317
	7,144

## 10. Associate Benefit Plans

### Stock Option Plan

The Company's 1997 Stock Incentive Plan (the "Plan") provides that options to purchase shares of the Company's unissued common stock may be granted to directors, associates and consultants to the Company at exercise prices which are equal to or greater than the fair market value of the Company's common stock on the date of grant. Options expire ten years after the date of grant or 90 days after termination of employment and generally vest ratably at the rate of 25% on each of the first four anniversaries of the grant date. New shares are issued to satisfy stock option exercises under the Plan. As of March 31, 2007, options to purchase 1.6 million shares of the Company's common stock were outstanding under the Plan.

In connection with the merger of the Company and the Iteris Subsidiary (Note 3), the Company assumed the 1998 Stock Incentive Plan of the Iteris Subsidiary (the "1998 Plan") and all outstanding options granted thereunder. As of March 31, 2007, options to purchase 3.6 million shares of the Company's common stock were outstanding under the 1998 Plan. No further options may be granted under the 1998 Plan.

Certain options granted under the Plan and the 1998 Plan (collectively, the "Plans") provide for accelerated vesting of unvested options in the event of a change in control under certain circumstances. These change-in-control provisions meet the criteria of a performance condition under SFAS 123R.

As of March 31, 2007, the Company had 711,000 outstanding stock options that were originally granted outside of the Plans and that were assumed by the Plan in connection with the merger of the Company and the Iteris Subsidiary (Note 3).



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A summary of activity in the Plans for the year ended March 31, 2007 is as follows:

	Options (In thousands, except per share amounts)	Weighted Average Exercise Price	Weighted Average Remaining Life (In Years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2006	6,977	\$ 1.42	4.0	
Granted	272	\$ 2.41	N/A	
Exercised	(1,374 )	\$ 0.81	N/A	
Forfeited	(23 )	\$ 2.86	N/A	
Expired	(34 )	\$ 2.13	N/A	
Options outstanding at March 31, 2007	5,818	\$ 1.60	3.4	\$ 6,115
Vested and expected to vest at March 31, 2007	5,730	\$ 1.59	3.4	\$ 6,106
Options exercisable at March 31, 2007	5,324	\$ 1.52	3.0	\$ 6,001
Options exercisable at March 31, 2007 pursuant to a change-in-control	5,818	\$ 1.60	3.4	\$ 6,115

At March 31, 2007, there were 9,000 options available for grant under the Plan.

For the years ended March 31, 2007, 2006 and 2005, the Company received \$1.1 million, \$296,000 and \$118,000, respectively, in cash from the exercise of stock options.

### Stock-Based Compensation Expense

Total stock-based compensation expense for the years ended March 31, 2007, 2006 and 2005 was \$288,000, \$725,000 and \$11.8 million, respectively. No income tax benefit was realized from activity in the Plans during the years ended March 31, 2007, 2006 and 2005.

The fair value of each stock-based award is estimated on the grant date using the BSM option-pricing formula.

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Expected volatility is based on the historical volatility of the Company's stock price. The expected life of options granted subsequent to the adoption of SFAS 123R is derived based on the historical life of the Company's options. The risk-free interest rate for periods within the expected life of the option is based on the U.S. Treasury interest rates in effect at the time of grant. The grant date fair value of options granted was estimated using the following weighted-average assumptions:

	Years Ended March 31,					
	2007		2006		2005	
Dividend yield	0.0	%	0.0	%	0.0	%
Expected life - years	7.0		7.0		7.0	
Risk-free interest rate	4.7	%	5.5	%	4.5	%
Expected volatility of common stock	0.9		0.5		0.5	

A summary of the grant date fair value and intrinsic value information is as follows:

	Years Ended March 31,		
	2007	2006	2005
(In thousands, except per share amounts)			
Weighted average grant date fair value per share of options granted	\$ 1.92	\$ 1.77	\$ 1.83
Intrinsic value of options exercised	\$ 2,288	\$ 295	\$ 20
Total fair value of options vested during the period	\$ 638	\$ 1,541	\$ 1,206

At March 31, 2007, there was \$855,000 of total unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted-average period of approximately 3.2 years.

### Associate Incentive Programs

Under the terms of a Profit Sharing Plan, the Company contributes to a trust fund such amounts as are determined annually by the Board of Directors. No contributions were made during the years ended March 31, 2007, 2006 and 2005.

In May 1990, the Company adopted a 401(k) Plan as an amendment and replacement of the former Associate Stock Purchase Plan that was an additional feature of the Profit Sharing Plan. Under the 401(k) Plan, eligible associates voluntarily contribute to the plan up to 15% of their salary through payroll deductions. The Company matches 50% of contributions up to a stated limit. Under the provisions of the 401(k) Plan, associates have thirteen investment choices, one of which is the purchase of Iteris, Inc. common stock at market price. Company matching contributions were approximately \$480,000, \$317,000, and \$409,000 and for the years ended March 31, 2007, 2006, and 2005, respectively.

### 11. Disposal of Fixed Assets

After the merger of the Iteris Subsidiary into the Company on October 2004, the Company reviewed and determined certain corporate property and equipment would not provide value to its on-going operations. These assets primarily consisted of furniture and fixtures and computer equipment. Accordingly, the Company recorded a \$422,000 loss on disposal of fixed assets in the year ended March 31, 2005.

### 12. Business Segment and Geographic Information

The Company currently operates in three reportable segments: Roadway Sensors, Automotive Sensors and Transportation Systems. The Roadway Sensors segment includes Vantage vehicle detection systems for traffic intersection control and certain highway traffic data collection applications. The Automotive Sensors segment is comprised of all activities related to AutoVue lane departure warning systems. The Transportation Systems segment includes transportation engineering and consulting services and the development of transportation management and traveler information systems for the ITS industry. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies except that certain expenses, such as interest, amortization of certain intangibles and certain corporate expenses are not allocated to the segments. In addition, certain assets including cash and cash equivalents, deferred taxes and certain long-lived and intangible assets are not allocated to the segments. The reportable segments are each managed



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separately because they manufacture and distribute distinct products or provide services with different processes. All segment revenues are derived from external customers.

Selected financial information for the Company's reportable segments as of and for the years ended March 31, 2007, 2006 and 2005 is as follows:

	<b>Roadway Sensors (In thousands)</b>	<b>Automotive Sensors</b>	<b>Transportation Systems</b>	<b>Total</b>
<b>Year Ended March 31, 2007</b>				
Product revenue from external customers	\$ 27,261	\$ 6,408	\$	\$ 33,669
Service and other revenue from external customers		2,579	22,049	24,628
Stock-based compensation	37	54	78	169
Depreciation	82	138	126	346
Allocated goodwill	8,197	4,671	14,906	27,774
Segment income (loss)	6,035	(2,625 )	2,551	5,961
<b>Year Ended March 31, 2006</b>				
Product revenue from external customers	\$ 22,446	\$ 5,865	\$	\$ 28,311
Service and other revenue from external customers		2,845	19,330	22,175
Stock-based compensation	177	101	342	620
Depreciation	132	189	266	587
Allocated goodwill	8,197	4,671	14,906	27,774
Segment income (loss)	3,420	(2,476 )	1,842	2,786
<b>Year Ended March 31, 2005</b>				
Product revenue from external customers	\$ 21,920	\$ 4,326	\$	\$ 26,246
Service and other revenue from external customers		2,816	17,335	20,151
Stock-based compensation	2,492	1,505	3,971	7,968
Depreciation	117	116	415	648
Allocated goodwill	8,197	4,671	14,906	27,774
Segment income (loss)	1,140	(3,109 )	(2,440 )	(4,409 )

The Roadway Sensors segment had one customer with revenue representing 26.5% of total segment revenue for the year ended March 31, 2007; one customer with revenue representing 25.9% of total segment revenue for the year ended March 31, 2006; and two customers with combined revenue representing 38.0% of total segment revenue for the year ended March 31, 2005. The Automotive Sensors segment had three customers with combined revenue representing 64.2% of total segment revenue for the year ended March 31, 2007; two customers with combined revenue representing 70.7% of total segment revenue for the year ended March 31, 2006; and two customers with combined revenue representing 85.2% of total segment revenue for the year ended March 31, 2005. The Transportation Systems segment had one customer with revenue representing 13.3% of total segment revenue for the year ended March 31, 2007; and one customer with revenue representing 14.9% of total segment revenue for the year ended March 31, 2005.

In connection with the October 2004 merger of the Iteris Subsidiary into the Company (Note 3), goodwill of \$8.0 million, \$4.7 million and \$5.3 million was allocated to the Roadway Sensors, Automotive Sensors and Transportation Systems segments, respectively. This allocation was determined based on the respective fair value of each segment as calculated using the income approach.

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The following reconciles segment income to consolidated income (loss) before income taxes and minority interest and segment assets to consolidated assets:

	March 31, 2007 (In thousands)	2006	2005
Segment income (loss)			
Total income (loss) for reportable segments	\$ 5,961	\$ 2,786	\$ (4,409 )
Unallocated amounts:			
Corporate and other expenses	(2,077 )	(1,972 )	(6,171 )
Amortization of intangible assets	(147 )	(147 )	(114 )
Deferred compensation (expense) benefit	91	(48 )	484
Disposal of fixed assets			(422 )
Acquired in-process research and development			(140 )
Other income (expense), net	(653 )	35	1,054
Interest expense, net	(1,600 )	(1,459 )	(1,178 )
Income (loss) before income taxes and minority interest	\$ 1,575	\$ (805 )	\$ (10,896 )
Assets			
Total assets for reportable segments	\$ 51,490	\$ 47,520	\$ 44,833
Unallocated assets	3,760	2,113	1,823
Total assets	\$ 55,250	\$ 49,633	\$ 46,656

The Company's revenues are generated and the Company's assets are held substantially in the United States.

### 13. Quarterly Financial Data (Unaudited)

	Net Sales (In thousands, except per share amounts)	Gross Profit	Net Income (Loss)	Basic Earnings (Loss) per Share	Diluted Earnings (Loss) per Share
June 30, 2006	\$ 13,816	\$ 5,719	\$ 279	\$ 0.01	\$ 0.01
September 30, 2006	14,466	5,957	732	0.03	0.02
December 31, 2006	14,488	5,676	310	0.01	0.01
March 31, 2007	15,527	6,656	1,597	0.05	0.05
	\$ 58,297	\$ 24,008	\$ 2,918	\$ 0.10	* \$ 0.09 *
June 30, 2005	\$ 12,079	\$ 5,355	\$ (726 )	\$ (0.03 )	\$ (0.03 )
September 30, 2005	12,715	5,442	(155 )	(0.01 )	(0.01 )
December 31, 2005	12,183	4,981	136	0.00	0.00
March 31, 2006	13,509	5,615	825	0.03	0.03
	\$ 50,486	\$ 21,393	\$ 80	\$ 0.00	* \$ 0.00 *

\* Annual per share amounts may not agree to the sum of the quarterly per share amounts due to differences between average shares outstanding during the periods.

## Schedule II

## Valuation and Qualifying Accounts (In thousands)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Accounts	Balance at End of Period
<b>Year Ended March 31, 2007</b>				
Deducted from asset accounts:				
Allowance for doubtful accounts	\$ 429	\$ 220	\$ 15	\$ 664
Reserve for inventory obsolescence	592	420	(168	) 844
<b>Year Ended March 31, 2006</b>				
Deducted from asset accounts:				
Allowance for doubtful accounts	\$ 239	\$ 275	\$ (85	) \$ 429
Reserve for inventory obsolescence	514	312	(234	) 592
<b>Year Ended March 31, 2005</b>				
Deducted from asset accounts:				
Allowance for doubtful accounts	\$ 204	\$ 37	\$ (2	) \$ 239
Reserve for inventory obsolescence	399	367	(252	) 514

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